Select Committee on Pension Policy

P.O. Box 40914
Olympia, WA 98504-0914
actuary_st@leg.wa.gov

September 7, 2004

10:00 AM - 1:00 PM

Senate Hearing Room 4
Olympia, Washington

REVISED AGENDA

10 AM **(1) Retiree Health Insurance**
– Bob Baker, Senior Research Analyst
– Pete Cutler, Acting Administrator, Health Care Authority

10:45 AM **(2) Age 65 Retirement**
– Laura Harper, Senior Research Analyst Legal

11:30 AM **(3) Pension Funding Council Recommendations**

12:30 PM **(4) Office of the State Actuary 05-07 Budget Request**
– Matt Smith, State Actuary

12:45 PM **(5) Appointment to the State Actuary Appointment Committee**

1:00 PM **(6) Adjourn**

Persons with disabilities needing auxiliary aids or services for purposes of attending or participating in Select Committee on Pension Policy meetings should call (360) 753-9144. TDD 1-800-635-9993

(360) 753-9144
Fax: (360) 586-8135
TDD: 1-800-635-9993

Meeting and Issue Schedule

(August 30, 2004)

April 20, 2004
10:00 AM - 12:30 PM
Senate Hearing Rm 4

Election of Officers
Session Update
Interim Work Plan
Meeting Dates

May 18, 2004
9:30 AM - 4:00 PM
Senate Hearing Rm 4

Orientation

June 15, 2004
10:00 AM - 12:30 PM
Senate Hearing Rm 4

Adequacy of Benefit
Military Service Credit

July 13, 2004
10 AM - 1 PM
Senate Hearing Room 4

Election of Chair
Adoption of Meeting Schedule
Purchasing Power
Post-Retirement Employment
Contribution Rate Setting

August 17, 2004
10 AM - 1 PM
Senate Hearing Room 4

Rules of Procedure
Gain-sharing
Purchasing Power - Options
PFC Audit and Recommendations

September 7, 2004
10 AM - 1 PM
Senate Hearing Room 4

Retiree Health Insurance
Age 65 Retirement
PFC Recommendations
OSA 05-07 Budget Request

October 19, 2004
10 AM - 1 PM
Senate Hearing Room 4

Age 65 Retirement - Options
LEOFF 1 Issues

November 9, 2004
10 AM - 1 PM
Senate Hearing Room 4

Plan 3 Vesting
Part-Time ESAs
Technical Corrections
Contribution Rate Setting

December 7, 2004
10 AM - 1 PM
Senate Hearing Room 4

Legislation

Select Committee on Pension Policy

P.O. Box 40914
Olympia, WA 98504-0914
actuary_st@leg.wa.gov

(360) 753-9144
Fax: (360) 586-8135
TDD: 1-800-635-9993

DRAFT MINUTES

August 17, 2004

The Select Committee on Pension Policy met in Senate Hearing Room 4, Olympia, Washington on August 17, 2004.

Committee members attending:

Representative Conway, Vice Chair	Leland Goeke
Representative Alexander	Robert Keller
Elaine Banks	Corky Mattingly
Marty Brown	Doug Miller
Senator Carlson	Glenn Olson
Representative Crouse	Senator Regala
Richard Ford	J. Pat Thompson
Representative Fromhold	

Representative Conway welcomed Philip Martin McCaulay, the newly hired Associate Actuary, Office of the State Actuary, and Matt Smith gave a brief summary of his background.

(1) SCPP Rules of Procedure

Laura Harper, Senior Research Analyst Legal, presented the "Draft Revisions to Rules of Procedure" report. The members discussed the OSA budget approval process.

Senator Carlson moved that the Rules of Procedure be amended to require that the OSA budget be approved by the Full Committee and that the rules be adopted as amended. Seconded.

MOTION CARRIED

(2) Gain-sharing

Laura Harper, Senior Research Analyst Legal, presented the report entitled, "Gain-sharing."

(3) Purchasing Power - Options

Bob Baker, Senior Research Analyst, presented the "Purchasing Power Options" report.

The following people testified:

Leslie Main - Washington State School Retirees' Association
Cassandra de la Rosa - Retired Public Employees Council

(4) Pension Funding Council Audit and Recommendations

Matt Smith, State Actuary reviewed the report entitled "Pension Funding Council Audit and Recommendations."

The meeting adjourned at 12:40 AM.

O:\SCPP\2004\9-7-04 Full\draft minutes 8-17-04.wpd

Retiree Health Insurance

(August 31, 2004)

Issue

Health insurance has become one of the most significant expenses retirees face, particularly those who leave employment before Medicare eligibility. Because the cost of health insurance continues to rise faster than the average change in consumer prices, it absorbs an ever-greater share of retirees' income, and can diminish the adequacy of their remaining retirement benefits. This paper will cover the current provisions related to retiree health insurance as it relates to members of State-administered retirement systems and plans. It will also discuss the nationwide trends in health care costs and how those costs have a greater impact on the elderly population. And to conclude, it will discuss the measures of health care inflation and which of those measures most closely reflects the experience of retirees.

Staff

Robert Wm. Baker, Senior Research Analyst
360-596-9237

Members Impacted

Members of all systems and plans except the Law Enforcement Officer's and Fire Fighters retirement system plan 1 whose members receive full health care coverage in retirement.

Current Situation

Currently, retired or disabled state employees, retired or disabled school employees, retired or disabled higher-education employees, or employees of county, municipal, or other political subdivisions who are retired may continue their participation in employer provided insurance plans and contracts after retirement or disablement. Separated employees may continue their participation if it is selected immediately upon separation from employment.

Surviving spouses and dependent children of emergency service personnel killed in the line of duty may also participate in insurance plans and contracts.

Premiums charged to retired or disabled employees, separated employees, spouses, surviving spouses of emergency service personnel killed in the line of duty, or dependent children who are not yet eligible for Medicare parts A and B are based on the experience of the community rated risk pool. The risk pool is comprised of employees of school districts and educational service districts, state employees, retired or disabled school employees not yet eligible for Medicare parts A and B, and state retirees not yet eligible for Medicare parts A and B. These premiums are *implicitly subsidized*, meaning that the large risk pool that includes active members lowers the premium for the retirees or inactive members.

Premiums charged to those who are eligible for Medicare parts A and B are calculated from their own experience risk pool. This premium is *explicitly subsidized*. Beginning with the 1995-97 budget, the legislature established a portion of the state, school district, and educational service district allocation to be used to provide a subsidy to reduce the health care insurance premiums charged to those retirees eligible for Medicare parts A and B. The amount of the premium reduction is established by the Public Employee's Benefits Board (PEBB), and cannot result in a premium reduction of over 50%. The current retiree premiums can be found in the PEBB pamphlet following this report.

According to the House and Senate Fiscal committee staff, in the 2003-05 biennium the state will pay close to $223 million dollars to subsidize health care insurance for 37,000 Medicare eligible and 10,800 non-Medicare eligible retirees. The estimated cost is evenly split between the implicit and the explicit subsidies.

History

The Health Care Authority (HCA) was established in 1988 (Ch. 107) to replace the State Employees' Insurance Board. In concert, the State Employee Benefits Board was established within the Health Care Authority to design and approve insurance benefit plans for state employees and retirees. The scope of the State Employees' Benefits Board has since been broadened to include employees and retirees of county, municipal, or other political subdivisions hence it has been named the Public Employees' Benefits Board (PEBB).

Recent Legislation

In 2002, the Legislature passed Substitute House Bill (SHB) 2536 (Ch. 142 L of 02) giving school districts that purchase PEBB coverage the ability to participate in the composite rating structure offered to state agencies. The bill required districts joining PEBB on or after September 1, 2002, to pay the entire composite rate charged by the HCA. SHB 2536 also required the school districts to charge their employees the same contributions as state employees.

In 2003, the Legislature passed Substitute Senate Bill (SSB) 5236 (Ch. 158 L of 03), which clarifies the way the HCA collects health care premiums from school districts. This bill affects those districts currently participating in the PEBB program as well as districts requesting participation in the future. The bill requires the HCA to collect the entire premium (composite + employee premium) from the district. However, it allows the employee portion of the PEBB premium to be determined at the district level, as long as the employee pays at least as much as a state employee. SSB 5236 became effective September 1, 2003.

Several bills were introduced in 2003 that did not pass the legislature. HB 1424 sought to create a statutory method for establishing the subsidies for retiree's health care premiums. HB 1425 attempted to open the enrollment in PEBB insurance programs to all TRS, PERS, and SERS retirees and their dependents. This would have allowed retirees who did not take advantage of the initial 60 day enrollment period, to enroll during an annual window. Neither of these bills received a hearing.

SB 5525 attempted to open the enrollment in PEBB insurance plans for separated (terminated-vested) plan 2 members who were at least age 55 and had 10 years of service. Plan 3 members are afforded this option. Plan 2 members currently must be receiving a retirement allowance to be eligible. This bill did not pass out of committee.

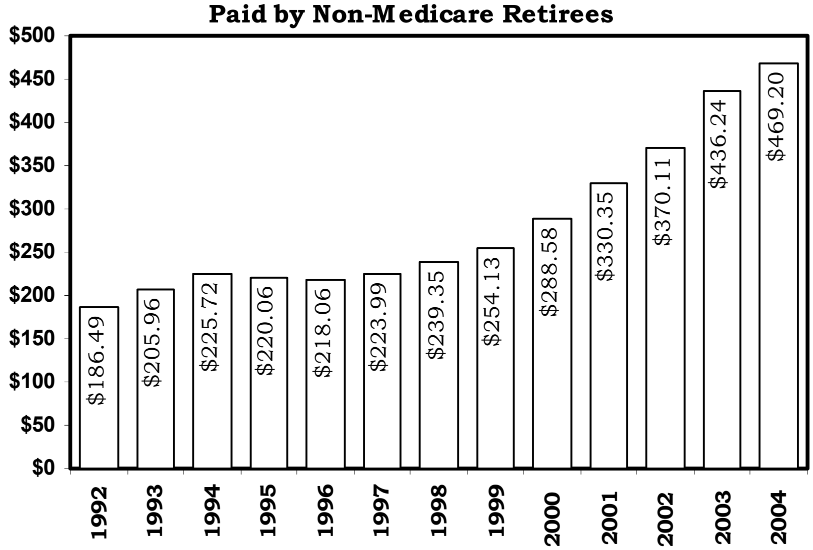
In 2004, HB 3192 attempted to create health savings account options for employees that conformed to section 223, Part VII of subchapter B of chapter 1 of the internal revenue code of 1986. The bill did not receive a hearing.

Retiree Premiums

As noted previously, retirees may purchase health insurance by paying the same premiums as are paid by their employers. Over the last ten years, retirees have paid premiums that have changed varying amounts from year to year. Some years they changed a modest amount, and some years, like 2004, they changed a great deal. The weighted average of the PEBB premiums paid by non-Medicare retirees from 1992 to 2004 is illustrated in Figure 1. The average premium increased by over 150% in this period, and most of that increase has occurred in the last 5 years.

Figure 1

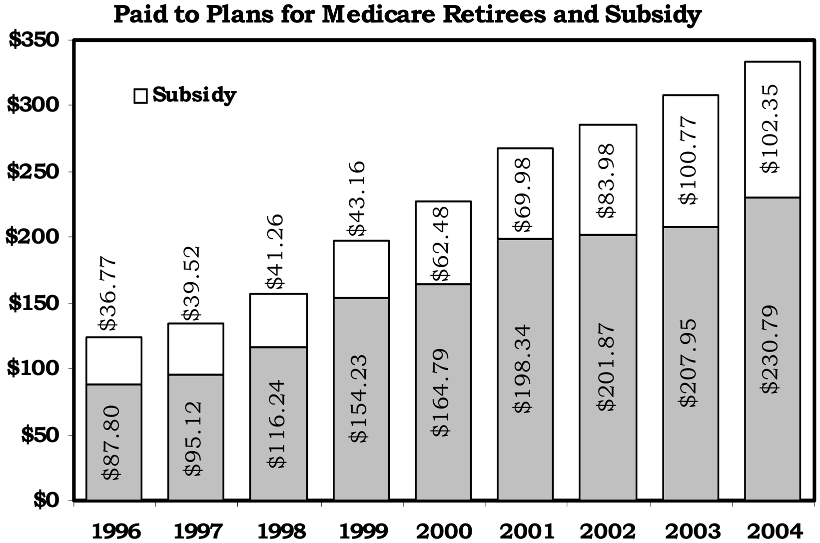
Average Monthly PEBB Premium Paid by Non-Medicare Retirees



The costs borne by Medicare-eligible retirees (age 65 and over) are typically about half that of non-Medicare retirees (see Figure 2). But even with the explicit subsidy, monthly premiums have increased at a 13% annual pace over the past 8 years. The subsidy to support Medicare-eligible PEBB retirees has kept up with these increases.

Figure 2

Average monthly PEBB Premium Paid to Plans for Medicare Retirees and Subsidy



The most recent premiums for 2004 vary from as little as $125 per month for a single subscriber who is already enrolled in Medicare parts A and B, to over $1,000 per month for a full family not yet eligible for Medicare (see Figure 3 and PEBB pamphlet for premiums by specific plan).

Figure 3
Monthly PEBB Retiree Rates
Effective July 1, 2004

Subscribers not eligible for Medicare or enrolled in Part A only	**Lowest**	**Highest**
Subscriber Only	$322.84	$374.71
Subscriber & Spouse	$641.84	$745.58
Subscriber & Child(ren)	$562.09	$652.86
Full Family	$881.09	$1,023.73 2
Subscribers enrolled in Parts A & B of Medicare		
Subscriber Only	$125.92	$241.34
Subscriber & Spouse (1 eligible)	$423.41	$612.21
Subscriber & Spouse (2 eligible)	$203.48	$478.84
Subscriber & Child(ren)	$345.36	$519.49
Subscriber & Child(ren) (2 eligible)	$203.48	$478.84
Full Family (1 eligible)	$667.63	$890.36
Full Family (2 eligible)	$445.18	$756.99
Full Family (3 eligible)	$303.30	$716.34
Dental Plans with Medical Plan		
Subscriber Only	$32.38	$39.05
Subscriber & Spouse	$64.76	$78.10
Subscriber & Child(ren)	$64.76	$78.10
Full Family	$97.14	$117.15

Medicare and PEBB

The new Medicare Part D prescription drug benefit in will also have an impact on retiree medical expenses. In 2004, those who are eligible will receive a 10-25% discount on prescription drug costs. In addition, low income enrollees

($12,569 annual income for an individual and $16,862 for a married couple) may receive a $600 per year credit to pay for their prescription drugs. In 2005, Medicare will provide physical exams within 6 months of enrollment in Part B, blood tests for early detection of heart diseases, and diabetes screening. In 2006, all people with Medicare will be able to enroll in plans that cover prescription drugs. Plans will have a $35 monthly premium and a $250 deductible. Thereafter Medicare will cover 75% of all costs up to $2,250 and 95% of all costs above $3,600. Individuals will be responsible for all prescription drug costs between $2,250 and $3,600.

Because of the variety of plans available to retirees enrolled through the PEBB, the Health Care Authority is still analyzing the impact of the Medicare changes in relation to each of those plans. *(See HCA summary of Medicare Prescription Drug, Improvement and Modernization Act of 2003 in Appendix A)*

Policy Analysis

No Pre-funded Medical Coverage

No retirement System/Plan administered by Washington State collects contributions to pre-fund retiree medical benefits. Currently, state, K-12, and higher-ed members who retire before age 65 are allowed to participate in their former employer's risk pool and purchase health insurance at subsidized rates. Even in LEOFF 1, member, employer, and state contributions do not pay for the medical benefits members receive upon retirement. While employers are obligated to provide LEOFF 1 retirees with medical coverage, that coverage is typically provided on a pay-as-you-go basis rather than being pre-funded (there is limited opportunity to pre-fund health insurance liability in a tax qualified trust).

Rising Health Care Expenditures

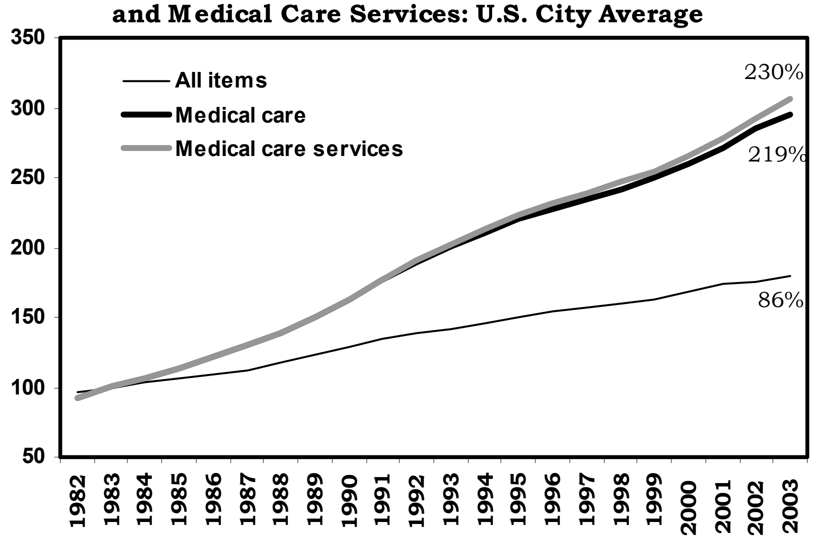
A significant risk facing retirees today is the rising cost of health care. As health care costs rise beyond the average of all other goods and services, they command a greater share of retirees income, forcing them to scale back on other living expenses and thus diminish the overall adequacy of their retirement benefit.

National Trends

As mentioned above, changes in health care costs have out-paced the change in price of other goods and services. In the period from 1982 to 2003, the overall change in consumer prices nationwide was 86%, or about 3% per year (see Figure 4). In comparison the cost of health care and health care services rose 219% and 230 % respectively, or about 6% per year.

Figure 4

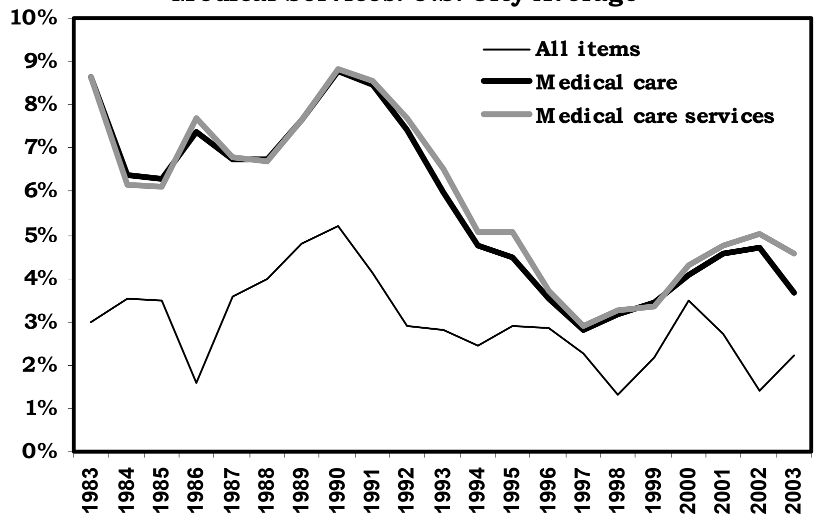
CPI-W for All Items, Medical Care, and Medical Care Services: U.S. City Average



While the cost of medical care may have moderated somewhat during this period, there was no year in which medical costs did not out pace the "all item" average (see Figure 5).

Figure 5

Annual % Changes in All Items, Medical Care, and Medical Services: U.S. City Average



For much of the 1990's, health care costs in this country were held in check. In spite of the tight labor market and strong economy, competitive pressures from domestic as well as international sources, and stringent monetary policies were able to keep annual changes in wages and consumer prices at modest levels. Because of this environment, health care benefits were economically feasible for employers to offer.

Recently this trend began to reverse. In 2001, employers experienced an average health care premium increase of 13%.[1] The National Conference of State Legislatures, citing Deloitte & Touche's September 2003 Employer Survey, reports that the costs of employer-sponsored health care plans rose 14.9% in 2003, from an annual $5,239 per employee in 2002 to $6,020 per employee. Survey respondents predicted that their 2004 plan costs would rise again an average of 14.3% to $6,880 per employee.

Nationally, health care spending in 2004 is projected to be $1.7936 trillion, or 15.5% of the total gross domestic product. This will be $6,167 per capita. However, during the next ten years health spending is expected to outpace economic growth. As a result, the health share of gross domestic product is projected to increase to 18.4% in 2013 according to the Office of the Actuary at the Centers for Medicare and Medicaid Services.

States Health Costs

As of January 1, 2004, 14 states reported a total employer/employee premium for family coverage of more than $900 per month according to the 2004 State Employee Benefits Survey by Workplace Economics Inc., a Washington, DC consulting firm. Fifteen states still pay the full cost of health care coverage for individual employees prior to Medicare eligibility, while just five of those states pay the full premium for family coverage. In most states, the amount paid by the employee and the state depends on the health plan and level of coverage selected by the employee. In four states - Illinois, Kansas, New Mexico, and West Virginia - the portion of the premium paid by the employee varies by salary. Forty-three states now offer pre-tax flexible spending accounts to assist employees with medical, dental, vision, life insurance, and other expenses not covered by health plans.

Washington Public Employee Benefit Costs

In the State of Washington, the price tag to provide health care coverage to state employees increased about 20% in 2003, with both state employees and state government paying more. The Acting Administrator of the Health Care Authority attributed this increase to a variety of factors, including the runaway increases in prescription drug costs, the aging workforce, and demands from doctors and other providers for higher reimbursements, and new technologies.[2]

According to Melissa Ahem, a health care economist and associate professor of health policy and administration at WSU Spokane, some of the driving forces behind rising health care costs are: consumers who want it all, from free choice of physician and loaded benefit packages to unlimited services; increasing numbers of uninsured, with associated costs for care delivered in hospital emergency rooms; increased direct-to-consumer marketing of pharmaceuticals; lack of personal responsibility for health, with more obesity, diabetes, heart disease, etc.; and the huge number of baby boomers moving rapidly toward being Medicare recipients.

Individual Health Expenditures Increase with Age

Individual health care expenses are impossible to predict, but even for healthy retirees, health care can be expensive. The average consumer age 65 and older pays not only a larger share of their income for health care, they also pay a greater absolute amount than someone in their peak earnings years (see Figure 6). According to the Bureau of Labor Statistics, Consumer Expenditure Survey, the average household whose head was age 45 to 54 paid $2,550 in health care expenditures in 2002, or 5.2% of their total household expenses. In comparison, the average household whose head was age 65 or older paid $3,586 in health care expenditures in 2002, or 12.8% of their total household expenses.

Figure 6

Average Consumer Expenditures by Age
Source: BLS, Consumer Expenditure Survey, 2002

	45 - 54		65 and Over	
	Dollars	Percent	Dollars	Percent
Total Expenditures	$48,748	100.0%	$28,105	100.0%
Food & Drink	$6,693	13.7%	$4,147	14.8%
Housing	$15,476	31.7%	$9,176	32.6%
Apparel	$2,029	4.2%	$972	3.5%
Transportation	$9,173	18.8%	$4,481	15.9%
Health Care	**$2,550**	**5.2%**	**$3,586**	**12.8%**
Entertainment	$2,565	5.3%	$1,139	4.1%
Miscellaneous	$3,367	6.9%	$1,638	5.8%
Cash Contributions	$1,571	3.2%	$1,679	6.0%
Insurance & Pensions	$5,323	10.9%	$1,286	4.6%

Moreover, paying for long-term care can wreak havoc on retirement savings. According to the American Health Care Association, the average American man can now expect to spend $56,895 on long-term care while the average American woman will spend close to double that, at $124,370. The price of long-term care is increasing around 7 percent a year. Medicare covers only about 50% of seniors' regular health expenses, excluding nursing home care. The American Association of Retired Persons/People estimates that the national average for the cost of one month in a nursing home is $4,654, or $55,848 annually (costs vary widely depending on geographic location).

Inflation and Retirement

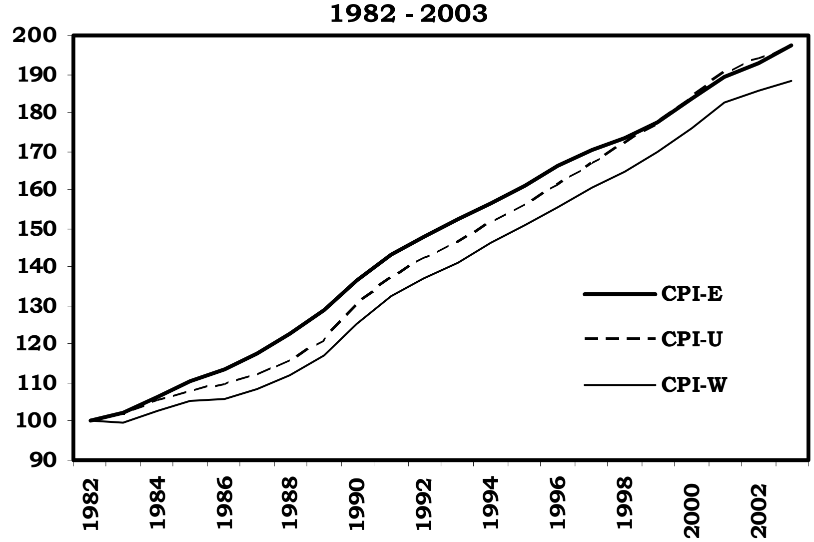
What is apparent from this analysis is that the Age 65 and Over population has distinctly different spending patterns than younger consumers. As a result, the Consumer Price Index for urban wage earners and clerical workers (CPI-W), which measures price changes in the market basket of a younger working population, would not necessarily be representative of the price changes experienced among older consumers. The CPI-W for the Seattle-Tacoma-Bremerton region is used to adjust the monthly allowances of retired members of the plan 2s.

The disparity in consumption patterns of retirees and workers was the concern driving the establishment of an experimental CPI by the U.S. Department of Labor, Bureau of Labor Statistics. Called the CPI-E, this index measures the changes in consumer prices experienced by the population age 62 and older – age 62 being the youngest at which a retiree may receive Social Security.

Comparing the changes in consumer prices as measured by the CPI-U (all urban consumers) and the CPI-W (wage earners and clerical workers) for the Seattle-Tacoma-Bremerton region, with the experimental CPI-E for the nation produces an interesting result. In the mid-to-late 1980s, the CPI-E rose more quickly than either of the two indices for the Seattle region (see Figure 7). By the mid-to-late 1990s, however, the Seattle CPI-U began to converge with the CPI-E and track in unison. As a result, the CPI-U for the Seattle region closely reflected the changes in consumer prices experienced by the Age 62 and Older population nationwide. What is unknown are the consumer price changes experienced by the local Age 62 and older population compared to the populations represented by the local CPIs.

Figure 7

Comparison of Consumer Price Indecies
1982 - 2003



Retiree Health Benefits Comparisons with Other States

Allowing retirees to pay subsidized premiums to continue their health coverage is a common benefit strategy employed by other states as illustrated in Figure 8. Of the systems examined, CalPERS, CalSTRS, Colorado, and Ohio provided for retiree health insurance through the retirement plans. Other comparable states' retirement systems may or may not administer the retiree health insurance, but it's the retirees who pay the bulk of the premiums.

Figure 8

Retiree Health Care Provisions by Select Retirement Plan

System	Pre-Medicare Eligible	Medicare Eligible
Cal PERS	Recent members need 20 yrs. service to receive 100% of state retiree medical contribution.	Member are eligible for supplemental benefits.
Cal STRS	Depends on bargaining agreement -- may be as much as full medical coverage depending on School District.	Members receive regular Medicare coverage
Colorado PERA	Members and dependents are eligible for PERA Care: subsidized medical, dental, and vision plans.	Members enrolled in Medicare part B are also eligible for PERA Care.
Florida (FRS)	Members may continue in employer provided group insurance plan and receive a subsidy of $5 per year of service to a maximum of $150.	Members continue to receive the $5 per year of service subsidy to a maximum of $150 per month
Idaho (PERSI)	Members are allowed to continue coverage in the group medical plan.	Members may purchase supplemental depending on employer.
Iowa (IPERS)	Members are allowed to continue with insurance group.	Members need to have both Parts A and B of Medicare and state becomes secondary payer.
Minnesota (MSRS)	Members are allowed to continue with insurance group (may pay into Health Care Savings Plan when employed.)	Members are eligible for a Medigap policy
Missouri (MOSERS)	Members and family are eligible to participate in any employer provided group insurance plans	Members and family are eligible to participate in any employer provided group insurance plans
Ohio (OPERS)	Majority of health premiums paid by OPERS. Remaining premiums deducted from the recipient's monthly benefit check.	Medicare part B reimbursed. Ohio plans become secondary payers.
Oregon PERS	Members may purchase group health and dental insurance.	Retiree may purchase Medicare companion insurance, state provides $60/month subsidy
Seattle (SCERS)	Members may continue coverage at group rates	Medicare supplemental insurance available

All 50 states make health insurance available to retirees up to the age of 65 and 48 states provide coverage under the state plan for retirees age 65 or older. In 11 states, the state pays the full cost of individual coverage for retirees under age 65, who are not yet eligible for Medicare. Seventeen states pay the full premium for Medicare-eligible retirees over the age of 65. Several states reported that the retiree's share of health care premiums depends upon the date hired, date of retirement or years of service at retirement.[3]

Other Washington Systems/Plans

All retired state, K-12, and Higher-education members of the systems/plans administered by Washington State are eligible to continue their health coverage if they pay the premiums formerly paid by their employer. The only system/plan that offers comprehensive medical coverage for retirees at no cost to the retiree is LEOFF 1, though retirees are still obligated to pay for coverage of their spouse and dependants. Contributions to LEOFF 1 plan, when necessary, required 6% of salary from both the employer and employee with any additional contributions provided by the State – historically double or triple the employer and employee rate. But even at this high level of funding, those contributions did not pay for retiree medical care; that is solely an obligation of the employer, and provided on a pay-as-you-go basis.

Benefits, Compensation and Retirement

Employment benefits have become an increasingly large part of the public employee's compensation package. These benefits include not just retirement plans, but also holiday, vacation, personal, funeral, jury duty, military, family, and sick leave; short-term disability, long-term disability, and life insurance; medical, dental, and vision care; and legally required benefits – unemployment insurance and worker's compensation. As these benefits command a higher share of the compensation package, particularly the "in lieu of wages" benefits like health care insurance, the difference between what is provided during employment and what is provided during retirement grows. As a result, the real replacement value of retirement benefits are lessened.

According to the PEBB rate tables an active PERS member with a spouse and child will receive, in 2004, a tax-free health care benefit from their employer worth upwards of $900 per month -- over $10,000 per year. As a result, the compensation of such a PERS employee could be over $55,000 per year because of the benefits that supplement that average $45,000 salary. For a 30-year employee, the current benefit structure replaces about 60% of salary, but less than 50% of compensation (see Figure 9). Because of the fixed nature of these benefits, lower wage members' retirement benefits replace less of their compensation, while the replacement rate is more for higher wage members.

Figure 9

Benefit Analysis: Salary and Health Insurance

	Salary for Retirement	Salary + Pre-retirement Health Insurance
Benefit Base	$45,000	$55,000
Retirement Benefit	$27,000	$27,000
Replacement Rate	60%	49%

Retirement benefits relative to total compensation is an issue because of the growing cost of health care and the differing definitions of compensation in Washington State. The statutory language in the PERS, SERS, and TRS retirement chapters limits compensation to essentially wages and salaries. The statutory language governing workers compensation benefits, which includes disability retirement, uses a definition of compensation that includes,"...wages, medical, dental, and vision benefits; room and board, housing, fuel, bonuses, and tips."

Note: Statutory language in the PERS and TRS plans includes the term "average final compensation" but define compensation so as to exclude all other components of the compensation package save wages and salaries. The LEOFF and State Patrol plans use the statutory term "average final salary."

Report Highlights

- State, K-12, and Higher-education retirees are allowed to purchase health insurance through the Public Employee's Benefits Board administered by the Health Care Authority.

- Current premiums range from a low of $125 per month for a single member enrolled in Medicare Parts A and B, to over $1,000 per month for a member with a spouse and child and not yet Medicare eligible.

- The 2004 weighted average premium for retirees not yet Medicare eligible was $469.20

- The 2004 weighted average premium for Medicare-eligible retirees was $333.14, of which $102.35 was subsidized.

- Total health care costs for State, K-12, and Higher Education retirees was an estimated $223 million in the latest biennium.

- Current retirement policies do not provide for pre-funded medical insurance.

- LEOFF 1 retirees receive full medical coverage on a pay-as-you-go basis.

- Consumer prices have risen 86% since 1982 while medical costs have risen upwards of 230%.

- Costs are up because of prescription drugs, aging workforce, higher reimbursements, new technologies, emergency room care for the uninsured, increased obesity, diabetes, and heart disease.

- Those 65 and older spent 12.8% of their annual household expenditures on health care.

- The Seattle CPI-U is more representative of consumer price changes experienced by retirees than the CPI-W.

- A few states pay for retiree medical through their retirement plans, but most subsidize retiree insurance premiums by allowing retirees to join an active member risk pool.

- The definition of “compensation” to calculate allowances in the retirement plans excludes employment benefits while the definition of “compensation” to calculate a disability retirement in the Workers Compensation system does include some employment benefits.

Endnotes

1. *Health Affairs, 2/11/04.*
2. *For a comparison of 2002 vs. 2003 employee contributions for health care costs, see the Health Care Authority's Press Release "State employees will pay more for health insurance," August 6, 2002 at www.hca.wa.gov.*
3. *2004 State Employee Benefits Survey, Workplace Economics.*

Appendix A

Medicare Prescription Drug, Improvement and Modernization Act of 2003 (MMA): Summary

This document provides summary information on two provisions of the MMA that may be of interest to the Select Committee on Pension Policy.

Part D and the Employer Subsidy

The MMA's highest profile provision was the creation of a drug benefit in Medicare. Currently there is no drug benefit in Medicare Parts A (facility), B (physician), or C (A & B risk/ Medicare Advantage). MMA creates Part D of Medicare, an optional drug benefit that becomes available effective January 1, 2006. Part D will be available through private risk bearing entities: Prescription Drug Plans (PDPs), and Medicare Advantage-Prescription Drug Plans (MA-PD).

Employers that offer retiree health coverage that includes a prescription drug benefit have several options in response to the creation of the Part D benefit:

1. Employers can collect an employer subsidy payment from Medicare for a portion of the drug costs of retirees and their Medicare dependants who do not sign up for Part D. To be eligible for the employer subsidy, the pharmacy benefit provided by the employer must be actuarially equivalent to the Part D benefit. It is not clear whether PEBB retiree coverage will meet that test based on the current retiree subsidy amount paid by the State for retirees.
2. Employers can wrap around the Part D benefit and coordinate with Medicare. The design of the Part D benefit includes a "True Out of Pocket Cost" requirement that makes coordination of benefits less attractive to employers. Amounts paid by employer based insurance do not count toward the beneficiary's True Out of Pocket Cost requirement, so the point at which the Part D catastrophic coverage kicks in is significantly delayed.
3. Employers can sponsor a PDP for their Medicare retirees.

Regulations governing Part D are not final, so analysis of these options is not complete.

Medicare Supplemental- Medigap

Effective 1/1/06, the MMA prohibits the selling, issuance, or renewal of existing Medigap policies with prescription drug coverage to Medicare Part D enrollees. Medigap policy holders may keep their policy with drug coverage and choose to NOT enroll in Part D, but could face a premium penalty should they choose to enroll in Part D at a later date. Also, MMA requests that the National Association of Insurance Commissioners (NAIC) review and revise standards for Medigap policies. The revision is to make the standard policies compliant with MMA and to include two new benefit packages.

NAIC has not formally adopted a new Medigap regulation, but has distributed a draft that is unlikely to see major revisions between now and when it is formally adopted. The draft regulation adds 2 new standard plans, K & L, to the existing plans A through J. In the draft the pharmacy benefit is removed from plans H, I, and J. And, in the draft, plans F and J have a high deductible option. PEBB currently offers plans E & J to its members.

MMA Summary Prepared by HCA
8/18/04

Retiree Health Insurance

Robert Wm. Baker
Senior Research Analyst

Select Committee on Pension Policy
September 7, 2004

Discussion Items

- Current Provisions
- Nationwide trends
- Impact on the elderly
- Measures of Health care costs

Members Impacted

- Members of all systems and all plans except LEOFF 1

Who May Participate

- Retired or disabled State, K-12, and Higher-ed members
- Surviving spouses and dependent children of emergency service personnel killed in the line of duty
- If selected immediately upon separation

Not Medicare Eligible

- Community rated risk pool
- Implicitly subsidized
  - Large pool that includes active members lowers premiums for retirees

Medicare Eligible

- Own experience risk pool
- Explicitly subsidized
  - Established by PEBB
  - Cannot reduce premiums by over 50%

Total Subsidy

- $223 million for current Biennium
- Split evenly between Medicare eligible and non-Medicare eligible retirees

Health Care Authority

- Established 1988
- Replaced State Employees’ Insurance Board
- State Employees’ Benefits Board
  – Public Employees’ Benefits Board

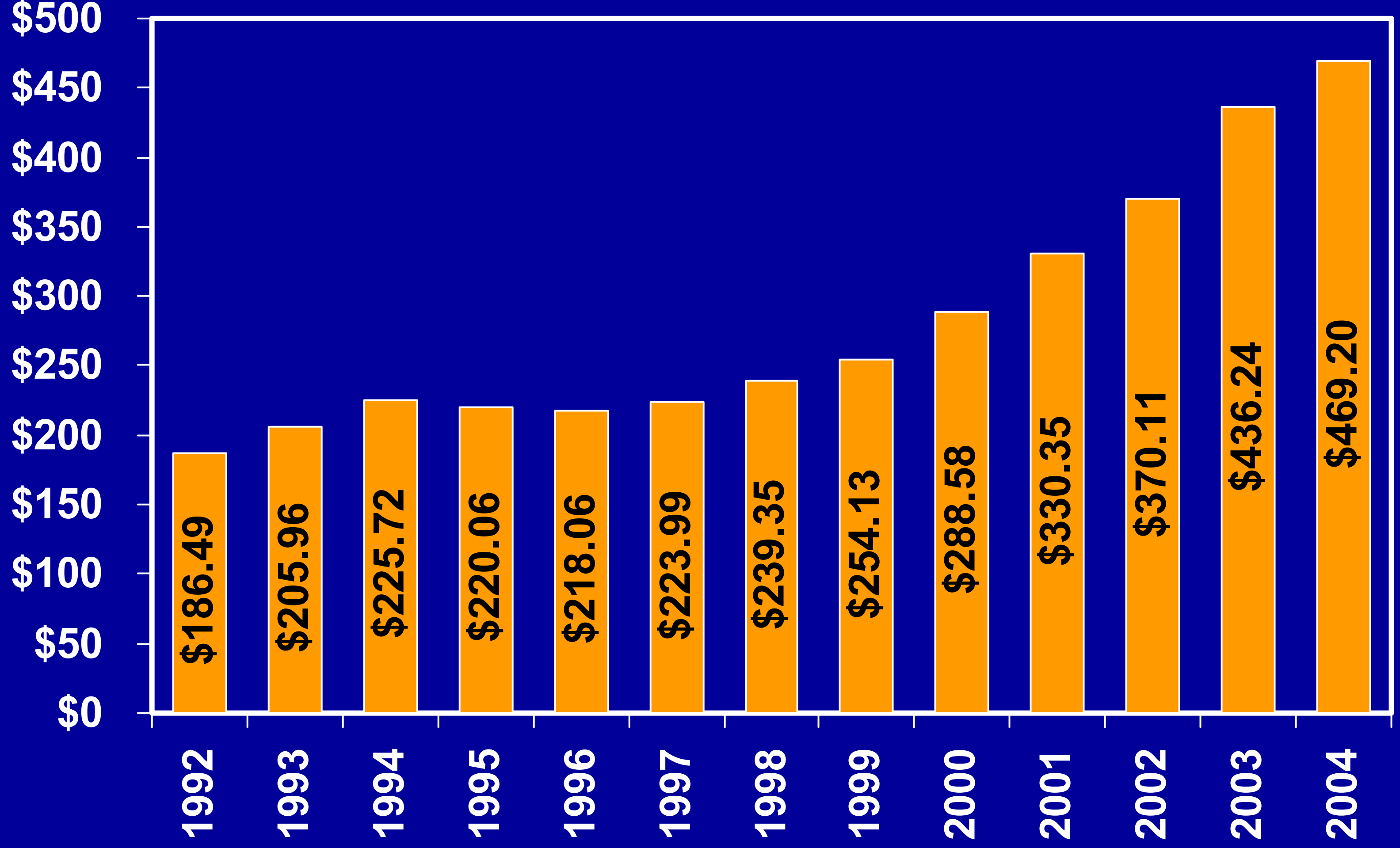
Recent Legislation

- Chapter 142 Laws of 2002
  - School districts in PEBB allowed to participate in composite rate structure
  - School districts charge their employees the same as state employees
- Chapter 158 Laws of 2003
  - Clarified the way HCA collects premiums from school districts

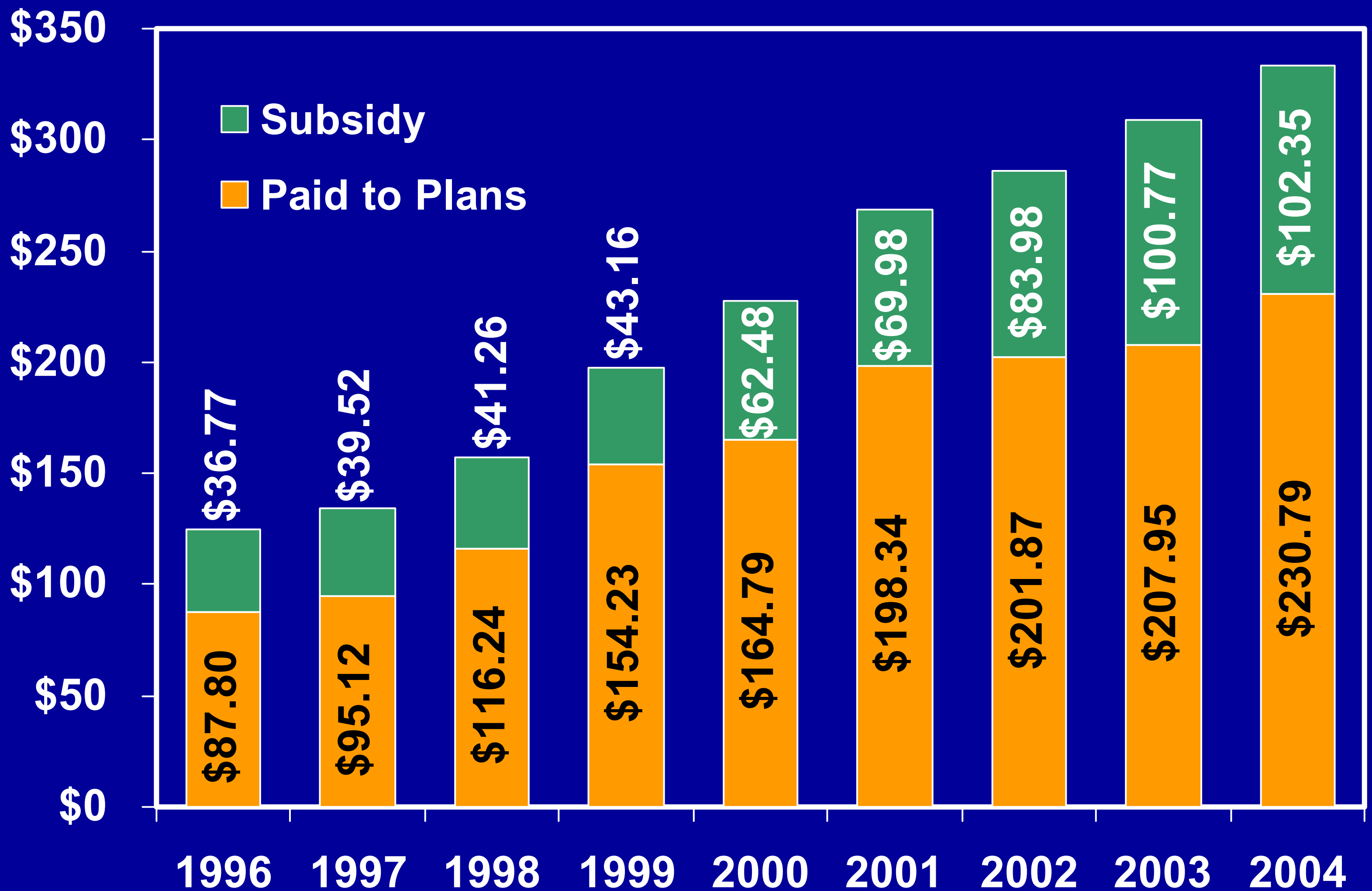
Recent Legislation

- HB 1424 (2003)
  - Statutory method for establishing subsidies
- HB 1425 (2003)
  - Open enrollment windows in PEBB
- SB 5525 (2003)
  - Allow terminated-vested plan 2 members to enroll in PEBB *
- HB 3192 (2004)
  - Create health savings accounts

Average Monthly PEBB Premium Paid by Non-Medicare Retirees



Average Monthly PEBB Premium Paid by Medicare Retirees and Subsidy



Medicare Part D

- 10%-25% discount on prescription drugs in 2004
  - Low income enrollees receive a $600 prescription drug credit
- Physical exams within 6 months of enrollment on Part B, blood test for early detection of heart disease, diabetes screening in 2005
- Enrollees in plans that cover prescription drugs in 2006

Medicare Part D

- Because of the variety of PEBB plans, HCA is still analyzing the impact of Medicare changes on each of those plans

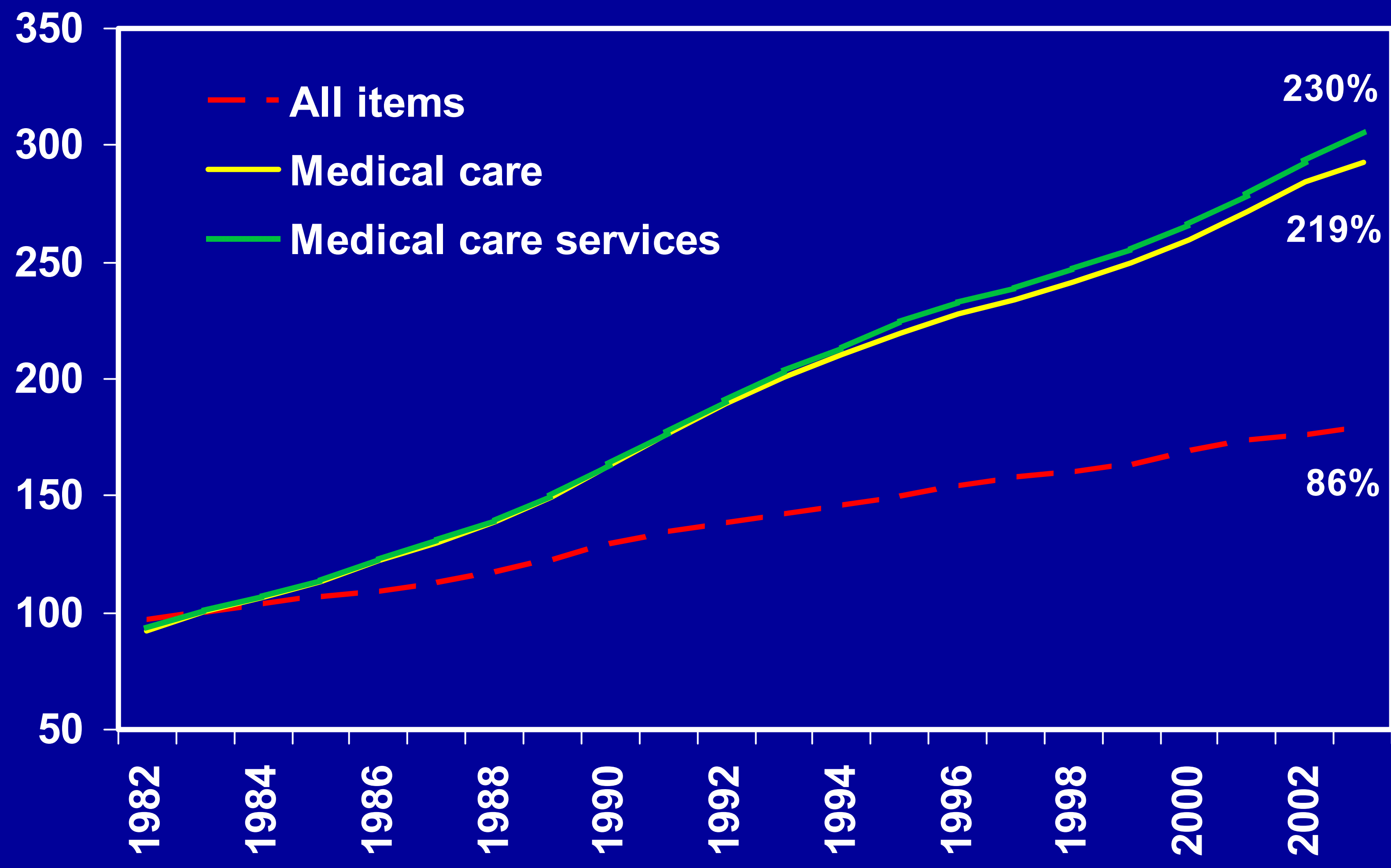
Policy Analysis

- No pre-funded medical coverage
  - LEOFF 1 is pay-as-you-go
  - Limited opportunity to pre-fund health insurance liability in a tax qualified trust
- State, K-12, and Higher-ed retirees may participate in PEBB at subsidized rates

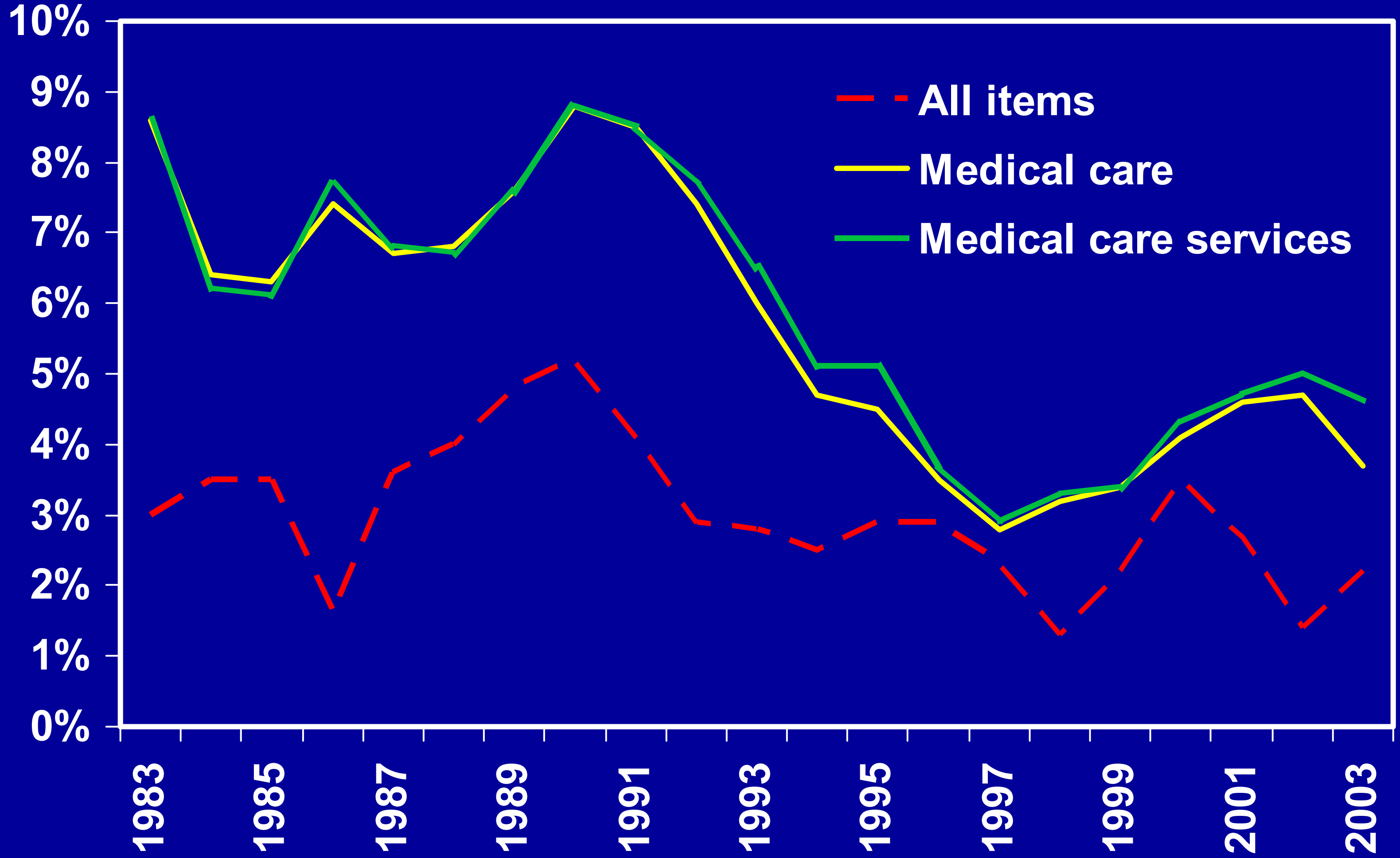
National Trends

- Health care costs rise faster than the average of all other items
  - Between 1982 and 2003 health care costs have risen twice as fast as the “all item” average
- Currently 15.5% of GDP
- May reach 18.4 % of GDP in 2013

CPI-W for All Items, Medical Care, & Medical Care Services: U.S. City Avg.



CPI-W for All Items, Medical Care, & Medical Care Services: U.S. City Avg.



States Trends

- 14 States reported premiums of $900 per month for family coverage in 2004
- 43 States have pre-tax flexible spending accounts for employee's medical expenses not covered by insurance

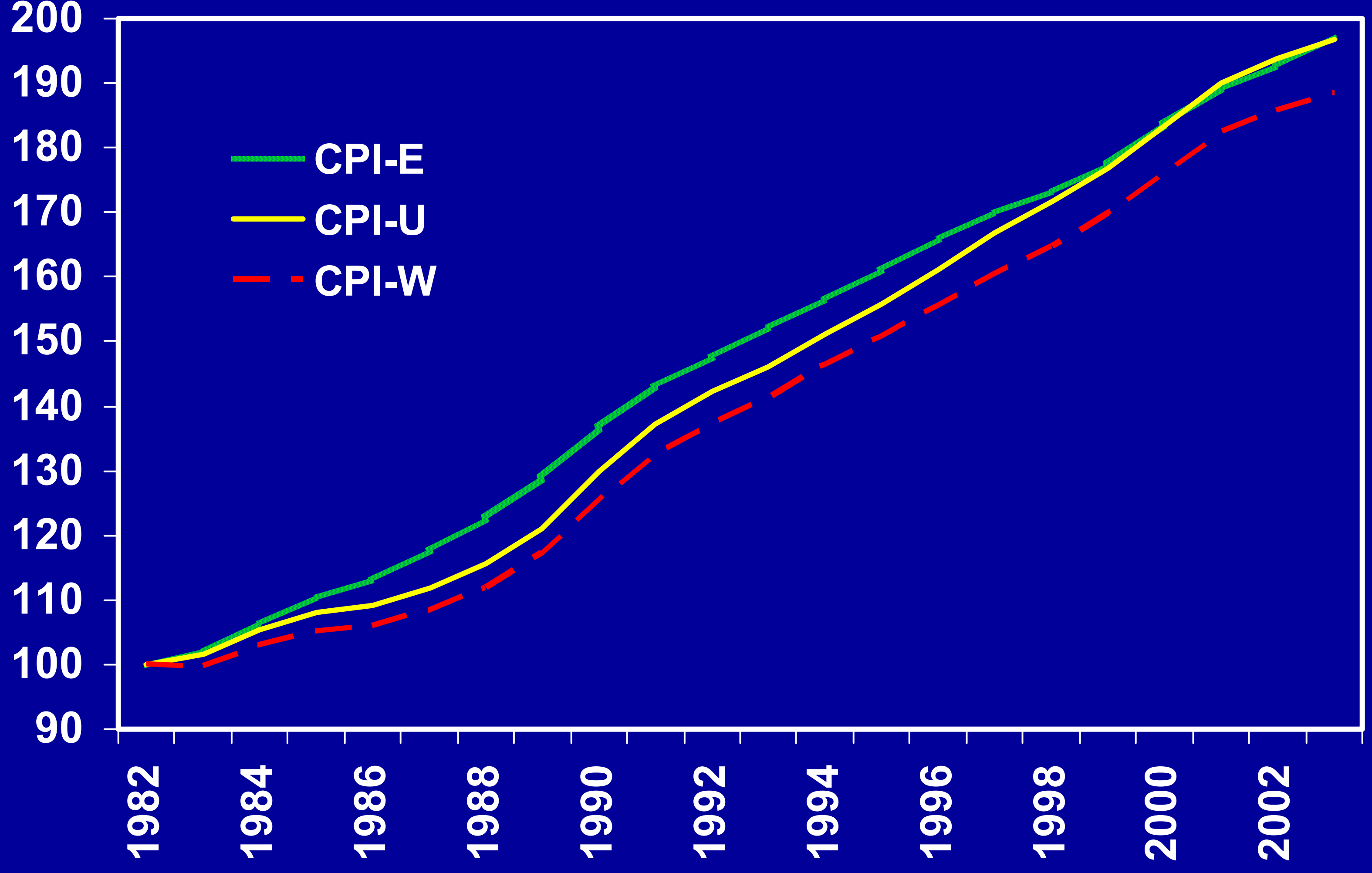
Washington Trends

- Costs for State employees increased 20% in 2003
  - Prescription drug costs
  - Aging workforce
  - Demands for higher reimbursements
  - New technologies

Average Consumer Expenditures by Age

	45 to 54		65 and Over	
	Dollars	Percent	Dollars	Percent
Food	$6,693	13.7%	$4,147	14.8%
Housing	$15,476	31.7%	$9,176	32.6%
Apparel	$2,029	4.2%	$972	3.5%
Transportation	$9,173	18.8%	$4,481	15.9%
Health	$2,550	5.2%	$3,586	12.8%
Entertainment	$2,565	5.3%	$1,139	4.1%
Miscellaneous	$10,261	21.0%	$4,603	16.4%

Comparison of Consumer Price Indicies : 1982 - 2003



Comparison States

- 3 offer health benefits as part of the retirement plan (California, Colorado, and Ohio)
- All others offer subsidized premiums

Comparison Systems/Plans

- LEOFF 1 provides retiree medical coverage
  - Paid by employer rather than system
  - Member pays for spouse coverage
- All others offer subsidized premiums

Employment Benefits as Compensation

- Retirement
- Leave
- Insurance
- Legally required benefits

Benefit Analysis: Salary and Health Insurance

	Salary for Retirement	Salary + Health Insurance
Benefit Base	$45,000	$55,000
Retirement Benefit	$27,000	$27,000
Replacement Ratio	60%	49%

Worker's Compensation

"...wages, medical, dental, and vision benefits; room and board, housing, fuel, bonuses, and tips."

Highlights

- State, K-12, and Higher-ed retirees are allowed to purchase subsidized health insurance through PEBB administered by the HCA
- Premiums range from $125 per month for a single Medicare enrollee, to over $1,000 per month for a member with a spouse and child and not yet Medicare eligible

Highlights

- The 2004 weighted average premium for retirees not yet Medicare eligible was $469.20
- The 2004 weighted average premium for Medicare-eligible retirees was $333.14, of which $102.35 was subsidized
- Total health care costs for State, K-12, and Higher-ed retirees was an estimated $223 million in the latest biennium

Highlights

- Current retirement policies do not provide for pre-funded medical insurance
- LEOFF 1 retirees receive full medical coverage on a pay-as-you-go basis
- Consumer prices have risen 86% since 1982 while medical costs have risen upwards of 230%

Highlights

- Costs are up because of prescription drugs, aging workforce, higher reimbursements, new technologies, emergency room care for the uninsured, increased obesity, diabetes, and heart disease
- Those 65 and older spent 12.8% of their annual household expenditures on health care

Highlights

- The Seattle CPI-U is more representative of consumer price changes experienced by retirees than the CPI-W
- A few states pay for retiree medical through their retirement plans, but most subsidize retiree insurance premiums by allowing retirees to join an active member risk pool

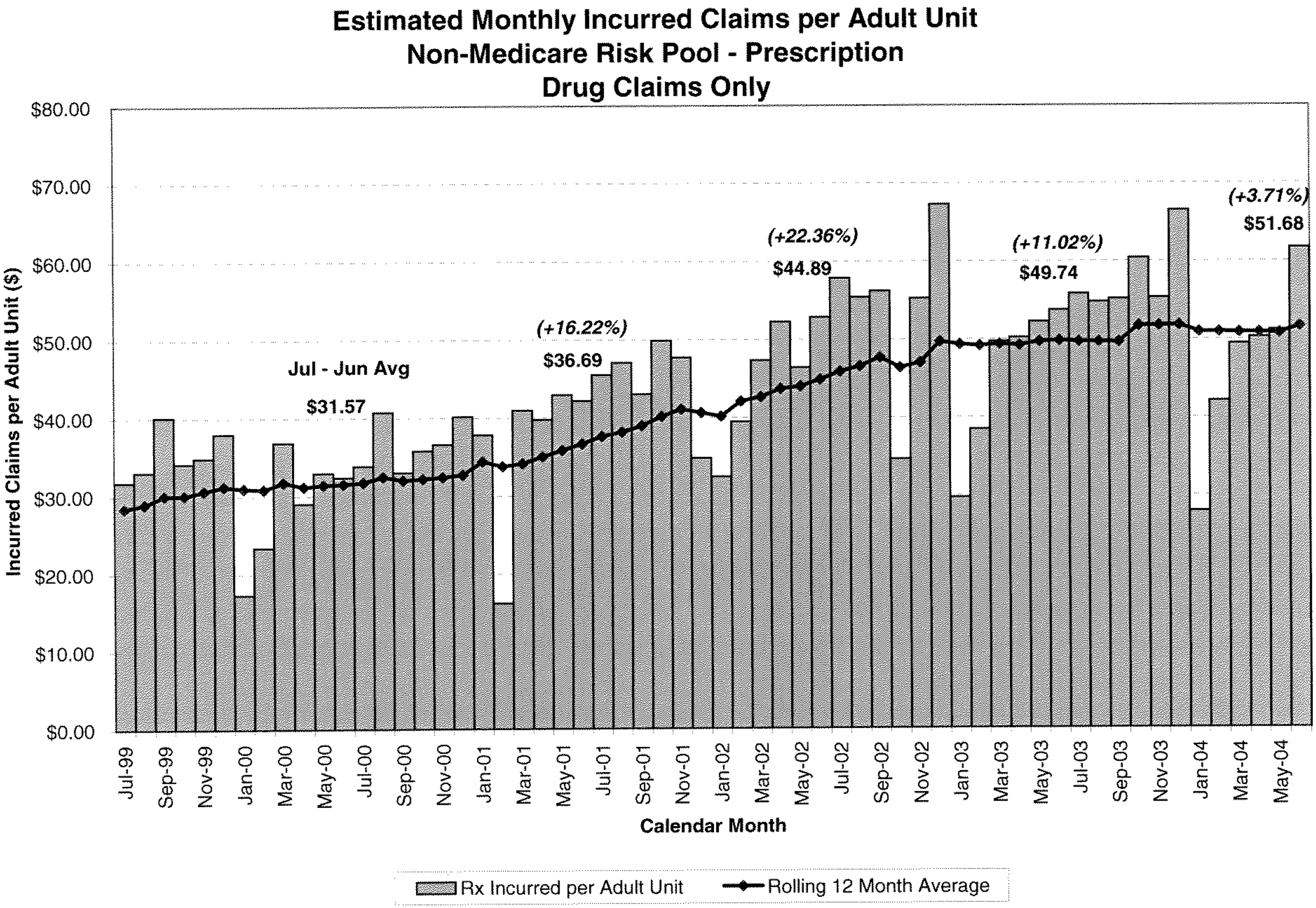
Highlights

- The definition of “compensation” to calculate allowances in the retirement plans excludes employment benefits while the definition of “compensation” to calculate a disability retirement in the Workers Compensation system does include some employment benefits

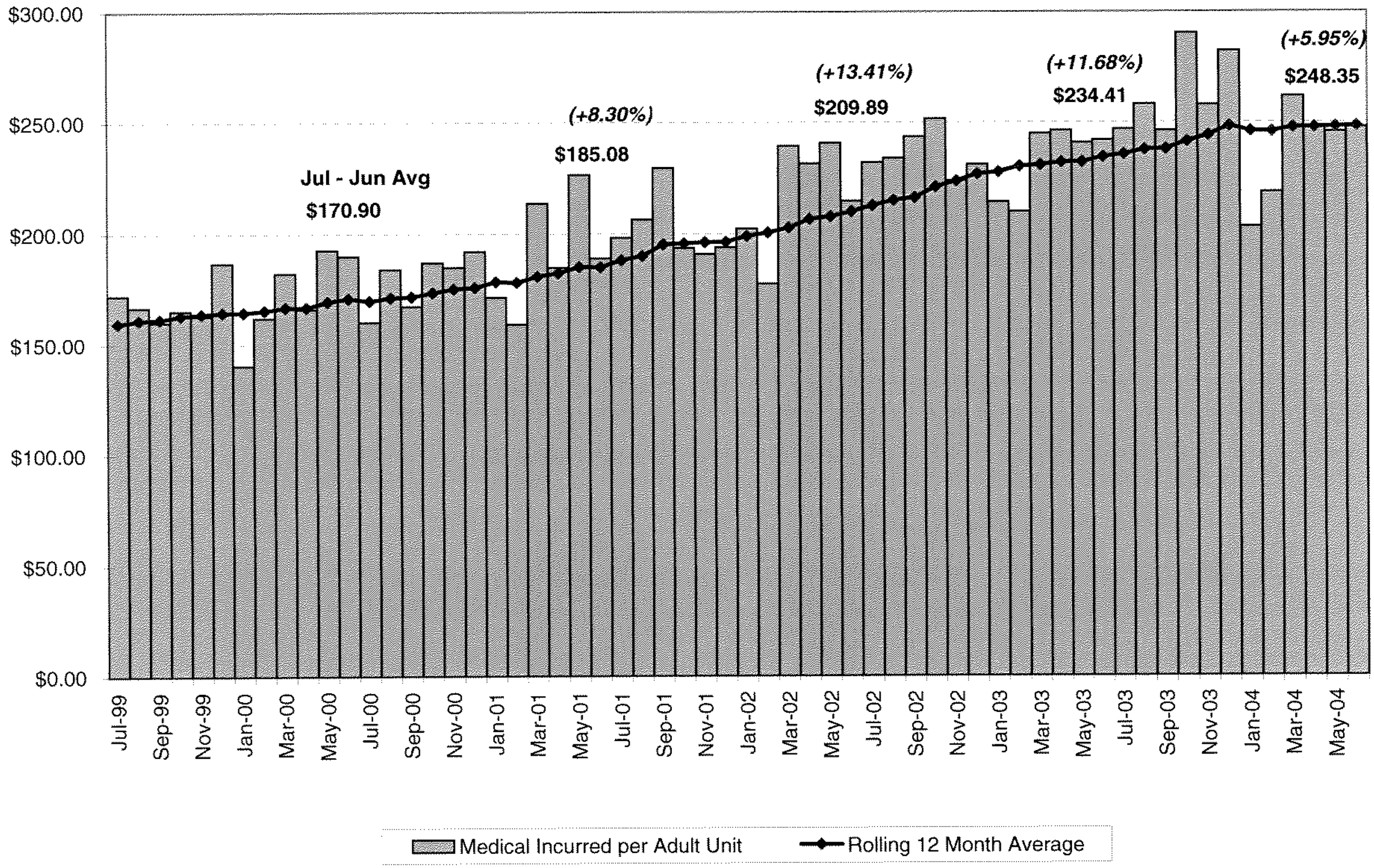
Washington State
Health Care Authority

Select Committee on Pension Policy
September 7, 2004

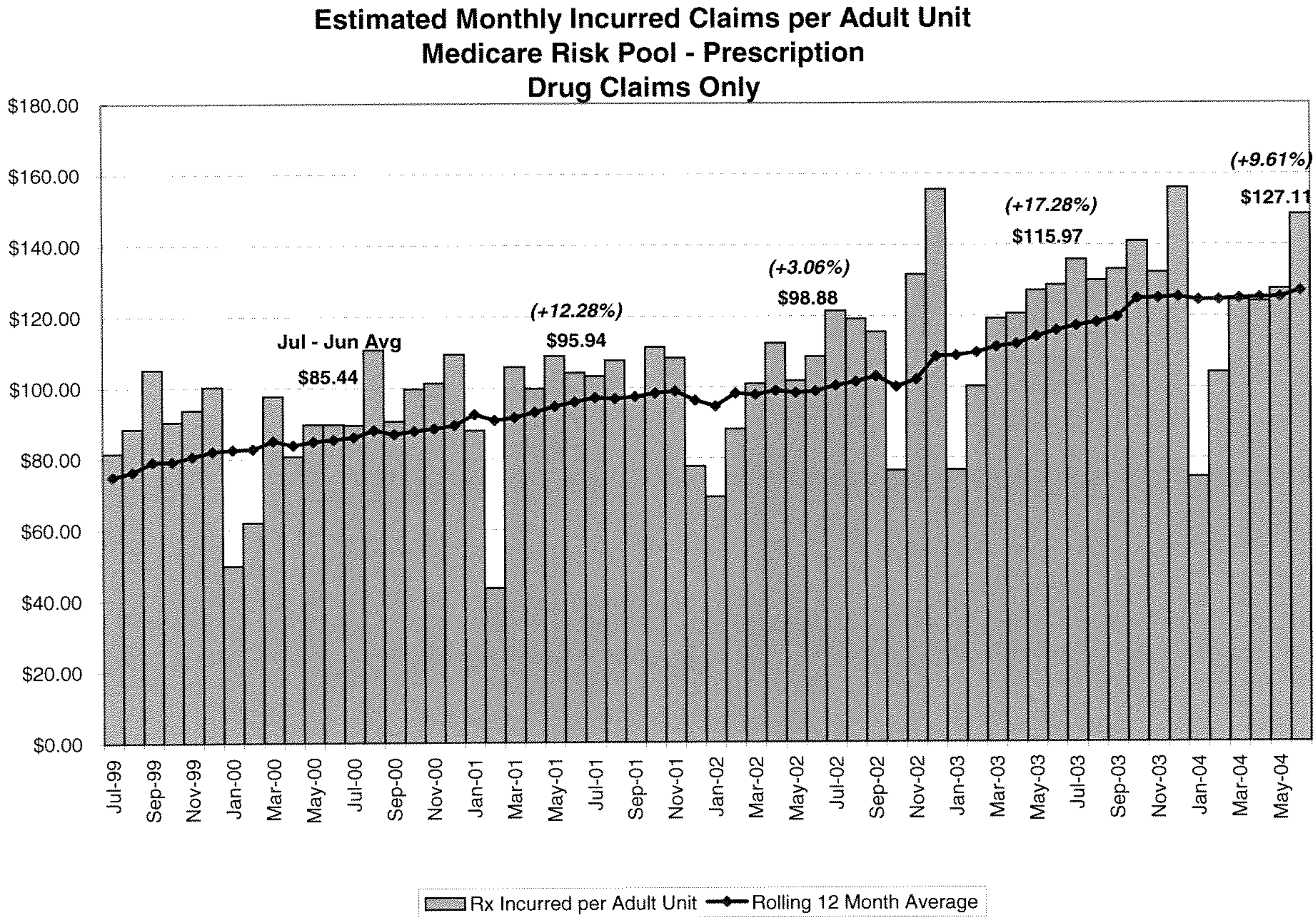
Pete Cutler, Acting Administrator
Health Care Authority


Estimated Monthly Incurred Claims per Adult Unit
Non-Medicare Risk Pool - Prescription
Drug Claims Only
$80.00
$70.00
$60.00
$50.00
$40.00
$30.00
$20.00
$10.00
$0.00
Incurred Claims per Adult Unit ($)
Jul - Jun Avg
$31.57
(+16.22%)
$36.69
(+22.36%)
$44.89
(+11.02%)
$49.74
(+3.71%)
$51.68
Jul-99
Sep-99
Nov-99
Jan-00
Mar-00
May-00
Jul-00
Sep-00
Nov-00
Jan-01
Mar-01
May-01
Jul-01
Sep-01
Nov-01
Jan-02
Mar-02
May-02
Jul-02
Sep-02
Nov-02
Jan-03
Mar-03
May-03
Jul-03
Sep-03
Nov-03
Jan-04
Mar-04
May-04
Calendar Month
Rx Incurred per Adult Unit
Rolling 12 Month Average

Estimated Monthly Incurred Claims per Adult Unit
Non-Medicare Risk Pool - Medical Claims Only

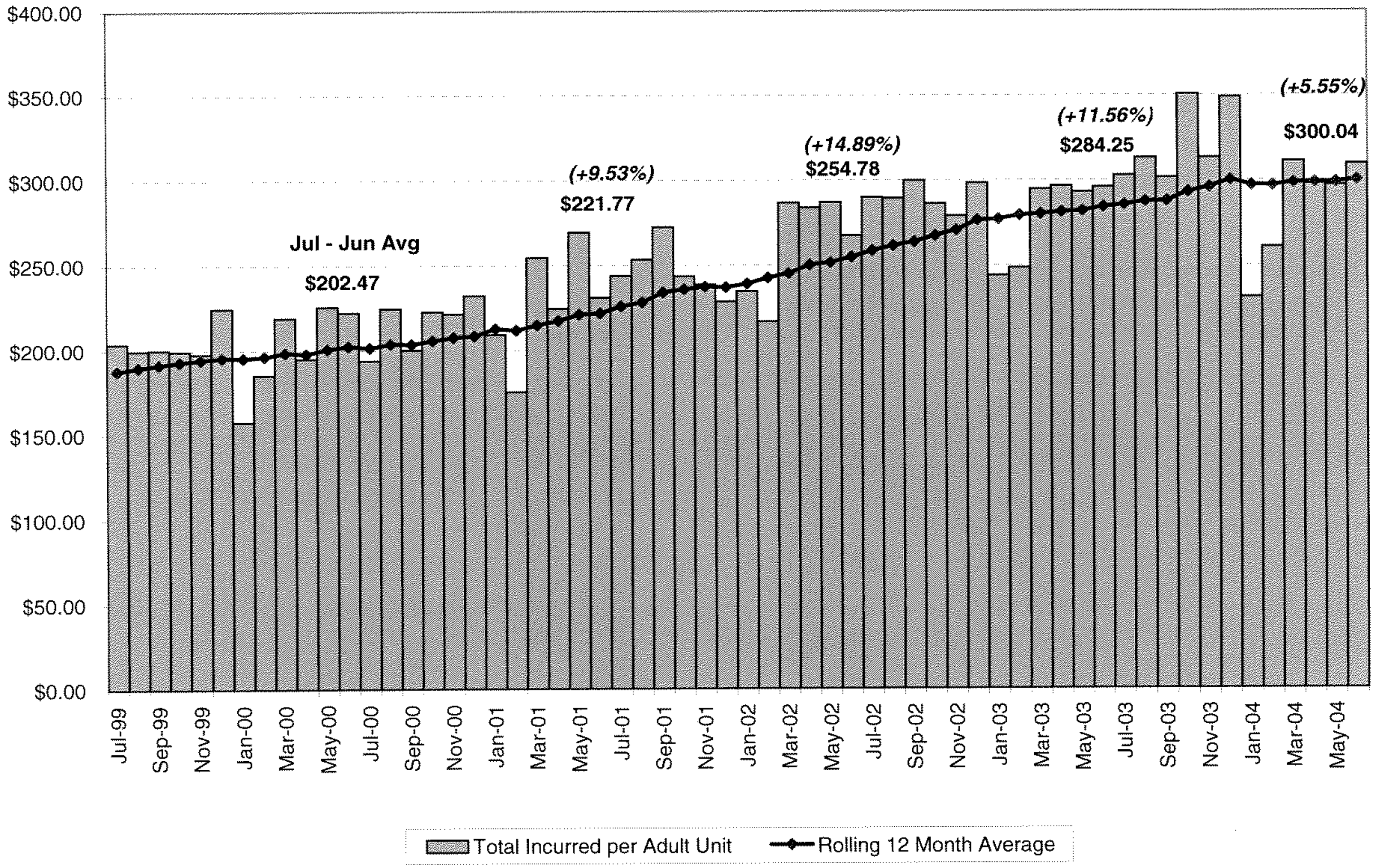


Washington State Health Care Authority **Attachment 9**
Uniform Medical Plan



Attachment 7

Estimated Monthly Incurred Claims per Adult Unit
Non-Medicare Risk Pool - Total Claims

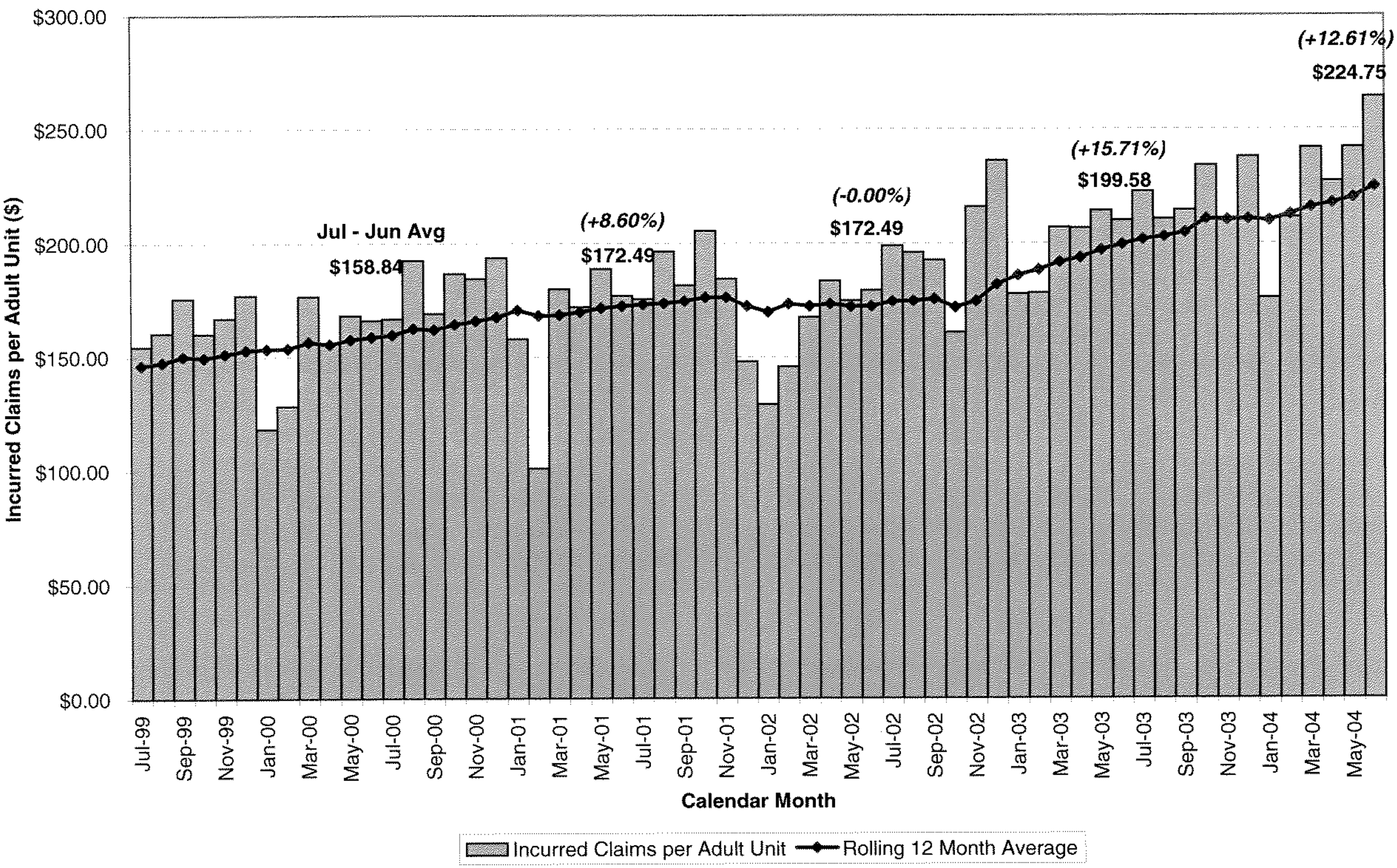


Washington State Health Care Authority

Uniform Medical Plan

Attachment 12

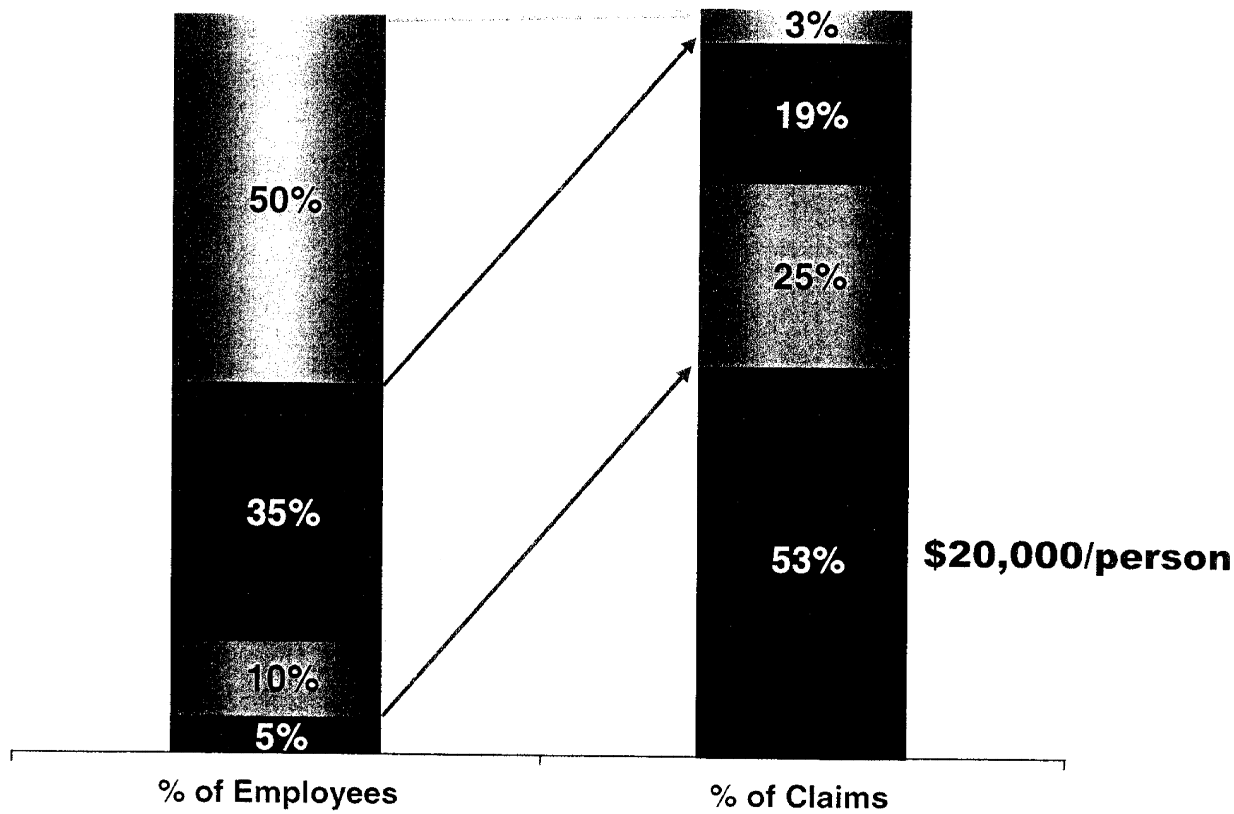
Monthly Incurred Claims per Adult Unit Adjusted for Benefits & Demographics
Medicare Risk Pool



Mercer

Large Claims Drive Much or Most of the Cost

A small percentage of employees account for a large percentage of claims



Washington State Health Care Authority

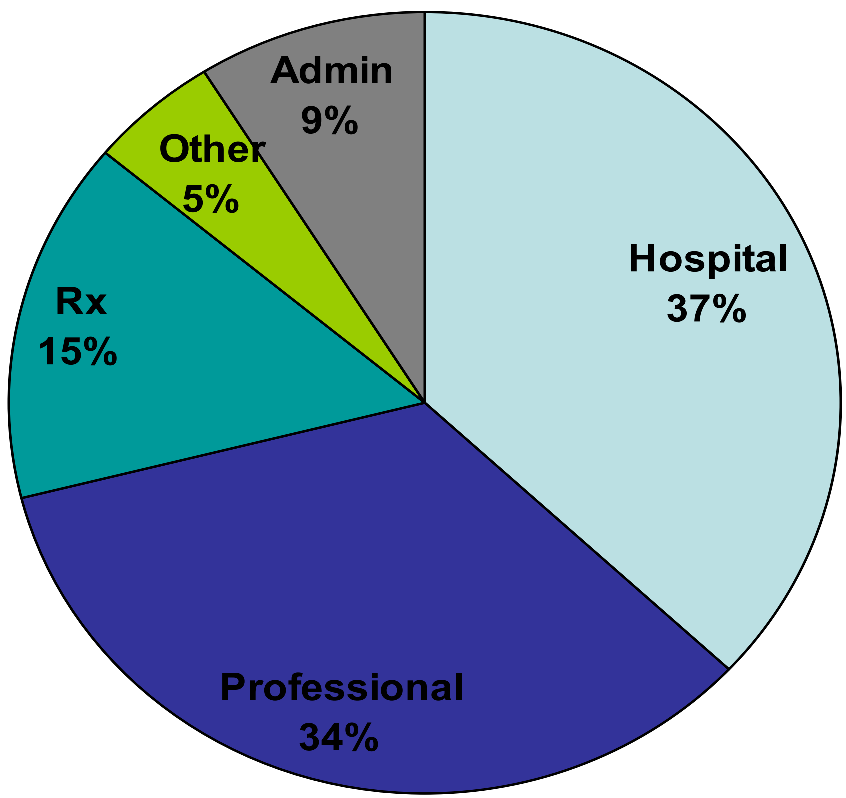
Contributing Factors to Higher Costs

- New technologies and treatments
  - Treating previously untreatable conditions
  - Improved treatments for other conditions
- Increased cost and dependency on prescription drugs
  - Increased marketing drives consumer demand
  - Coverage for “lifestyle” drugs
- Increased utilization
  - Smarter consumers demanding more services
  - Population is getting older
    - Average age of PEBB enrollee is 42 - it was 38 in 1997

Washington State Health Care Authority

Components of Health Insurance Dollar

PEBB 2002 Experience



CY 2002 UMP Major Payment Groups

- CY 2002 Major UMP Payment groups

Item	Patients	Cost
Joint degeneration, localized, w/ surgery	1,566	$7,728,822
Joint degeneration, localized, w/o surgery	11,359	$6,314,641
Benign hypertension, w/o co-morbidity	15,927	$4,692,413
Routine exam	28,684	$4,516,362

- Some big ticket items, with far fewer patients

Item	Patients	Cost
Malignant neoplasm of the breast, with surgery other than BMT	417	$3,673,468
Chronic renal failure, with ESRD	478	$3,538,799
Neoplastic disease of blood and lymphatic system except leukemia	625	$3,401,032

Uniform Medical Plan High Cost Enrollees

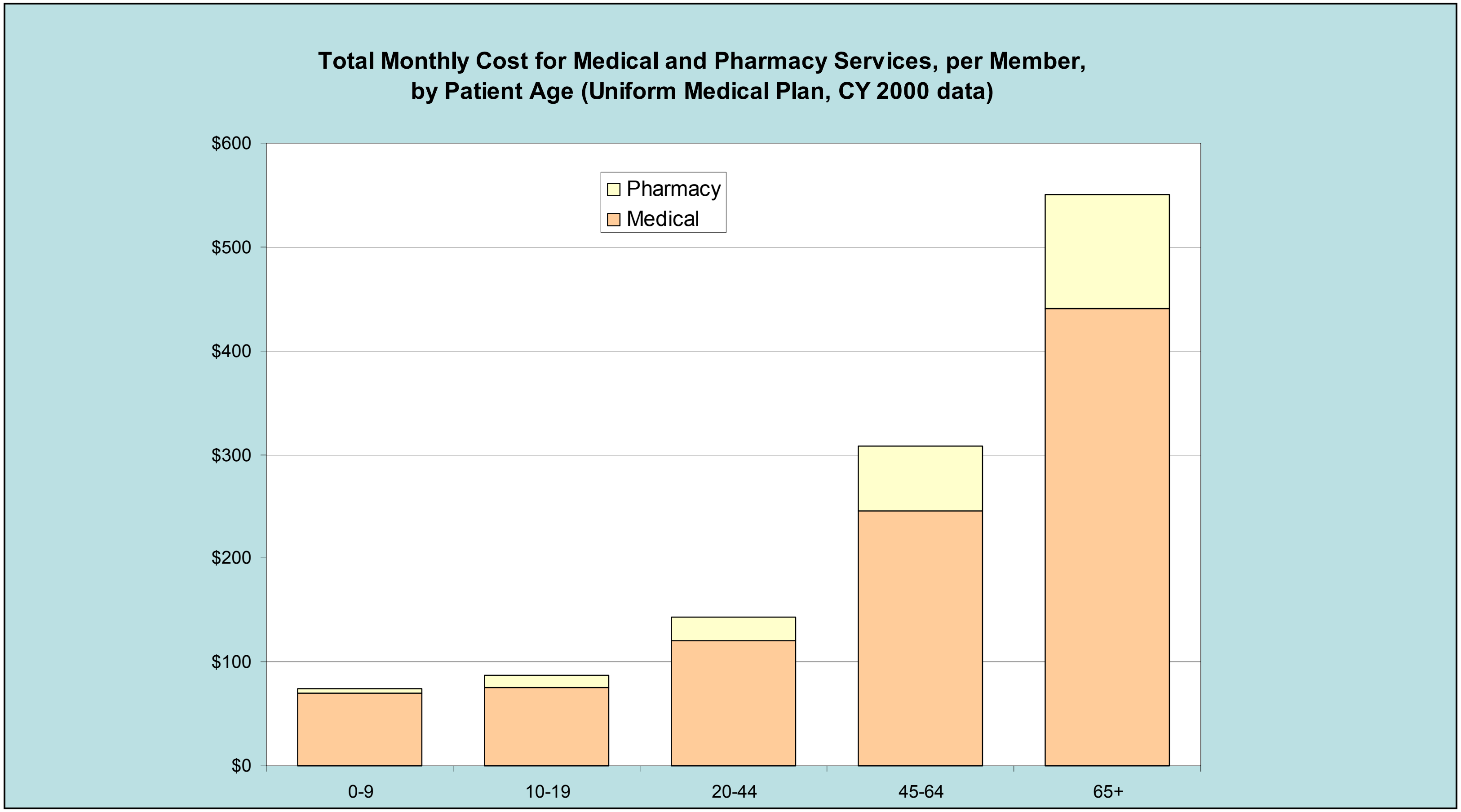
UNIFORM MEDICAL PLAN
HIGH COST ENROLLEES
NON-MEDICARE RISK GROUP, CY2003
(includes medical and pharmacy claims)

Percent of enrollees w/total CY2003 UMP payments >$100,000	161
Total CY2003 UMP payments for these enrollees	$27,437,289
Percent of all active/non-Medicare enrollees	0.20%
Percent of total CY2003 payments for active/non-Medicare enrollees	11.32%

2002 Uniform Medical Plan payments for top 5% of utilizers comprised 41% of total payments made

Washington State Health Care Authority

UMP/PEBB - An Aging Population



Age 65 Retirement

(September 1, 2004)

Issue

Both employers and employees have expressed concern over the normal retirement age in the PERS , TRS and SERS Plans 2/3. The normal retirement age for these plans is currently set at age 65. As background information for this interim's initial work session on the issue, this report summarizes the history relevant to the formation and design of the Plans 2/3, with a focus on aspects of plan design that affect retirement eligibility. As part of this history, the report will summarize findings from the 1992 Plan 2 Retirement Age Report as Authorized by the Joint Committee on Pension Policy. This report will further examine why the Plans 2/3 have a normal retirement age of 65, and will identify the existing policies that would be impacted or changed if the retirement age were lowered. Preliminary cost estimates for lowering the retirement age from 65 to 60 and 62 are also provided.

Staff

Laura C. Harper, Senior Research Analyst/Legal
360-586-76166

Members Impacted

Lowering the normal retirement age would impact active and terminated-vested ("term-vested") members of the Plans 2 and 3 of the Public Employees' Retirement System (PERS), the Teachers' Retirement System (TRS) and the School Employees' Retirement System (SERS). The following table summarizes the numbers of participants in the Plans 2/3 based on the most recent actuarial valuation (using 2003 data) that would be impacted by a proposal to lower the normal retirement age:

	PERS 2	PERS 3	TRS 2	TRS 3	SERS 2	SERS 3
Active	114,876	17,411	7,507	47,109	20,748	27,226
Term-Vested	15,678	766	2,450	2,394	1,846	1,621

Current Situation

The Plans 2/3 have age-based retirement eligibility. To be eligible for normal retirement, members of the Plans 2/3 must be vested and must reach age 65. The Plans 2 are defined benefit plans, and the vesting period for these plans is five years. The Plans 3 are hybrid plans, with a defined benefit component and a defined contribution component. Plan 3 members are immediately vested in their defined contribution accounts, and become vested in the defined benefit portion of their benefit after ten years of service, or after 5 years of service if 12 months of service were accrued after attaining age 54.

History

The **Plan 1 systems** have service-based retirement eligibility and provide retirement benefits at ages prior to when members are expected to permanently leave the workforce. These plans were very costly due to the need to maintain an adequate benefit over 30 years or more. The **Plan 2** systems were created in 1977 in response to three major problems that were identified for the Plan 1 systems:

1. High cost of disability retirements in LEOFF Plan 1;
2. Increasing pressure for Cost-of-Living Adjustments (COLAs) in TRS and PERS; and
3. Increasing costs of the Plan 1 systems.

<u>See</u> Plan II Retirement Age Report as Authorized by the Joint Committee on Pension Policy, Washington State Legislature, October, 1992 ("1992 Report").

Due to legal constraints, the Legislature then, as now, could not reduce benefits for current employees. Instead, new systems were intended to be designed in such a way as to minimize future risks, and hence costs. The creation of the Plan 2 systems was to generate significant costs savings for the State of Washington - an estimated $15.9 billion over a 25 year period according to projections at that time. Primarily, the savings were the result of the general fact that it is less costly to maintain an adequate retirement benefit over a shorter period of time. Also, Social Security and Medicare help augment benefits more quickly in plans with higher retirement ages.

The 1992 Report identified significant member dissatisfaction with the Plans 2. The most basic concerns appeared to be:

- Employee organizations believed their members should be able to collect a pension after completing a certain number of years of service ("service-based" retirement) rather than after permanently leaving the workforce ("age-based retirement").
- Employees who left prior to retirement did not feel they received "reasonable value" from the retirement system, creating pressure to allow early retirement as the only way to get value.
- The interest credited to member accounts had been less than market rates and the trust fund earnings.
- Members had almost no flexibility in the form and/or timing of their benefits.

In September of 1993, the Joint Committee on Pension Policy (JCPP) proposed retirement benefit policies in connection with discussions of a possible new "**Plan 3**" to "meet the needs of employees, retirees and employers within available resources." Joint Committee on Pension Policy Proposed Retirement Benefit Policies, September 1993. The policies inherent in the Plan 2 systems that would be continued were:

1. All state and local employees should have essentially the same retirement plans.
2. Retiree benefits should have some form and degree of protection from inflation.
3. Costs should be shared equally between employees and employers.

In addition, the JCPP would base any new plans or changes to the Plans 2 on the following additional policies:

Total Retirement Income

- Sufficient income after leaving the workforce should be from a combination of Social Security, retirement benefits and employees' savings.
- Employees must take responsibility for insuring that they have a sufficient income after retirement.

Purpose of Retirement Benefits

- Retirement benefits are intended to provide income after leaving the workforce.
- Employees who vest and leave should be provided reasonable value toward their ultimate retirement for their length of service.

Flexibility

- Retirees should have more flexibility in determining the form and timing of their benefit.
- Plan design should be as neutral as possible in its effect on employees:

  - It should not inhibit employees from changing careers or employers.
  - Employees should not be encouraged to stay in jobs they consider highly stressful.
  - Employees should not be encouraged to seek early retirement.

In 1995 the TRS Plan 3 Retirement System was created. The Plan became effective in 1996. The creation of TRS 3 was followed by creation of the SERS Plans 2/3 in 1998. These plans became effective in 2000. Finally, in 2000, an optional PERS 3 was enacted. It became effective in 2002.

The Plan 3 policies that were finally adopted by the legislature are found in RCW 41.34.010:

1. Provide a fair and reasonable value from the retirement system for those who leave public employment before retirement.
2. Increase flexibility for such employees to make transitions into other pubic or private sector employment.
3. Increase employee options for addressing retirement needs, personal financial planning, and career transitions.

4. Continue the legislature's established policy of having employees contribute to their retirement benefits.

Policy Analysis

In the Plans 2, the retirement age was established as the time when the member was presumed to leave the workforce. It broke with the well-established tradition within the Plans 1 of providing a retirement benefit after completion of a career. The policy rationale was that the retirement system was to provide a benefit for retirement when the member leaves the workforce and no longer draws a salary. This same philosophy was continued for the Plans 3. While members of these plans may extend their careers or pursue new career options, the retirement benefit is not paid until the member is presumed to have left the workforce.

Raising the normal retirement age in the Plans 2 and Plans 3 was in direct opposition to the national trend which for more than 20 years has been to reduce normal retirement ages. As reported to the SCPP at its May orientation by Ron Snell of the National Conference on State Legislatures, 26 of the 100 largest retirement systems allow retirement at age 62 with 5 or more years of service, and 56 systems allow normal retirement at age 60 with 5 or more years of service. Also, 56 of the largest 100 systems allow early retirement (with reduced benefits) at age 55 with 5 or more years of service.

A review of the handbooks and websites for Washington's comparative public employee retirement systems revealed a range of normal retirement ages as summarized in the following table. Normal retirement ages are considered for the purposes of this comparison to be those at which members will receive unreduced retirement benefits. Early retirement provisions are not included within this comparison. The following table summarizes the age and service requirements for normal retirement in the open plans within the comparative systems.

Normal Retirement Age Comparisons

Retirement System	**Normal Retirement Age/ Years of Service**
CalPERS	63*
CalSTERS	60/1
Colorado (PERA)	50/30, 60/20, 65/5
Florida Retirement System	62/6, Any age/30
Idaho (PERSI)	65/5
Iowa (IPERS)	65, 62/20, Rule of 88
Minnesota State Retirement System	66 *(65 if born before 1938)*
Missouri (MOSERS)	65/4 *(active)*, 65/5, 60/15, Rule of 80 *(at least age 48)*
Ohio PERS	65/5, *(Traditional and Combined Plans)*, 55 *(Member Directed Plan)*
Oregon Public Service Retirement Plan *(for those hired after 8/28/03)*	65, 58/30
City of Seattle	62/5, 60/20, Rule of 80 from age 52-59, Any age/30

**2.5% benefit factor at age 63, 2.0% benefit at 55/5*

Both employers and employees in Washington have expressed concern over the normal retirement age in the Plans 2/3. At the May 18, 2004 Orientation, "age 65 retirement" was listed as the number 3 priority for the SCPP. Also, "working until age 65" is one of the issues that the SCPP forwarded from last year for study during the 2004 interim.

Why age 65?

The 1992 Report identified age 65 as the generally accepted full (or normal) retirement age as established by Social Security. Today the full retirement age under Social Security is increasing. As explained on the Social Security Administration's website, www.ssa.gov, Americans are living longer, healthier lives and can expect to spend more time in retirement than their parents and grandparents did. See also Adequacy of Benefit, Report to the SCPP, June 2004 for more information on the aging workforce. Today Social Security's full retirement age of 65 applies only to those born in 1937 or earlier. For those born after 1937, a full retirement age schedule has been adopted. The later the birthday, the later the full retirement age. For example, those who are born in 1960 and later have a full retirement age of 67. Persons covered by Social Security can retire as early as 62, but their benefits are reduced to take into account the longer period of time they will receive them.

Year of Birth	Full Retirement Age
1937 or earlier	65
1938	65 and 2 months
1939	65 and 4 months
1940	65 and 6 months
1941	65 and 8 months
1942	65 and 10 months
1943-1954	66
1955	66 and 2 months
1956	66 and 4 months
1957	66 and 6 months
1958	66 and 8 months
1959	66 and 10 months
1960 and later	67

Plan 2/3 Tradeoffs

The Plan 2/3 designs incorporated two benefits that were not available to members of the Plans 1:

1. An annual cost-of-living adjustment after one year of retirement based on the CPI-Seattle to a maximum of 3%; and

2. Removal of the 60% cap on average final compensation (AFC).

These benefits reflected a tradeoff. Members would have shorter retirement periods than they would have had under the service-based Plans 1, but would enjoy increased financial security. Not only would Plan 2/3 members' purchasing power be protected throughout retirement by a stable and predictable COLA, but also members of the Plans 2/3 would be rewarded for working into their later years by allowing them to earn an increased monthly retirement benefit.

Figures 1-4 compare PERS 1 and PERS 2 plan provisions based on a hypothetical retiree with salary increases of 4.5% per year prior to retirement, inflation at 3.5% annual rate (actuarial assumption) and social security (SSI) beginning at age 66 when the member would receive an unreduced benefit. These figures illustrate that while PERS 2 can't replace as great a share of salary as PERS 1 at early retirement ages, it can at later ages, and at all ages it maintains a more constant benefit.

Figure 1
PERS & SSI Benefits as a % of Final Pay
After 25 Years of Service at Age 55

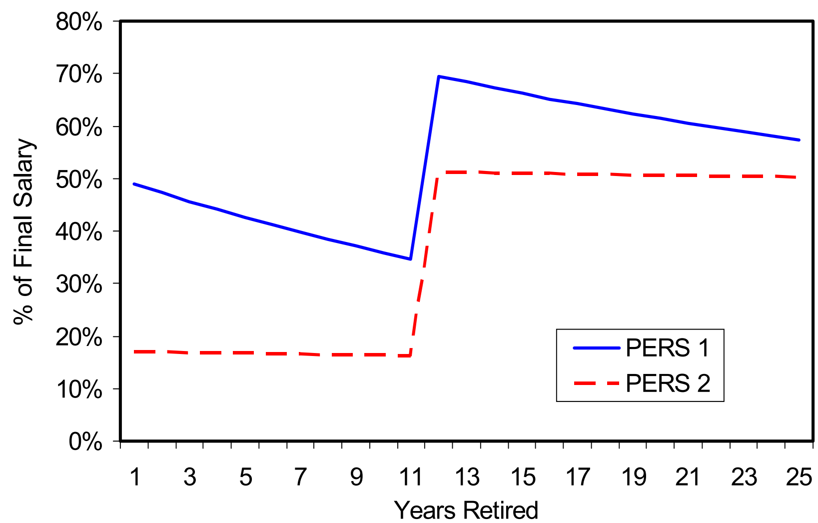


Figure 2
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 55

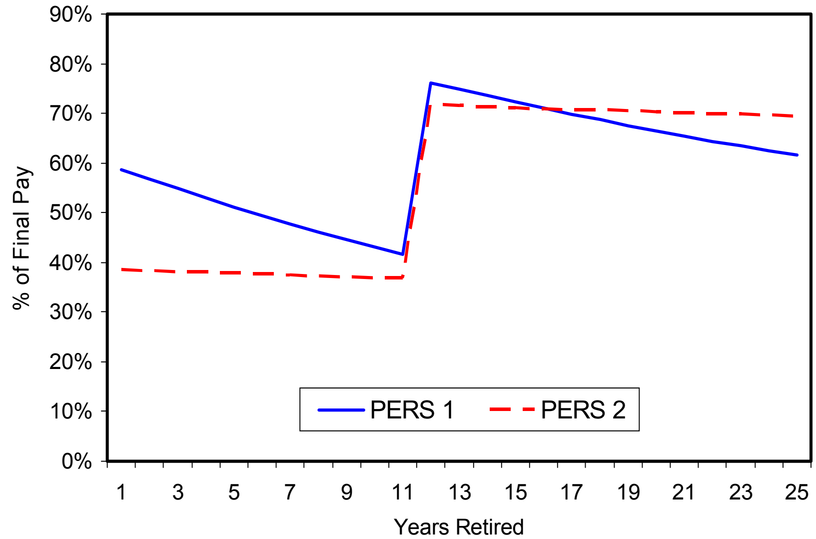


Figure 3
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 60

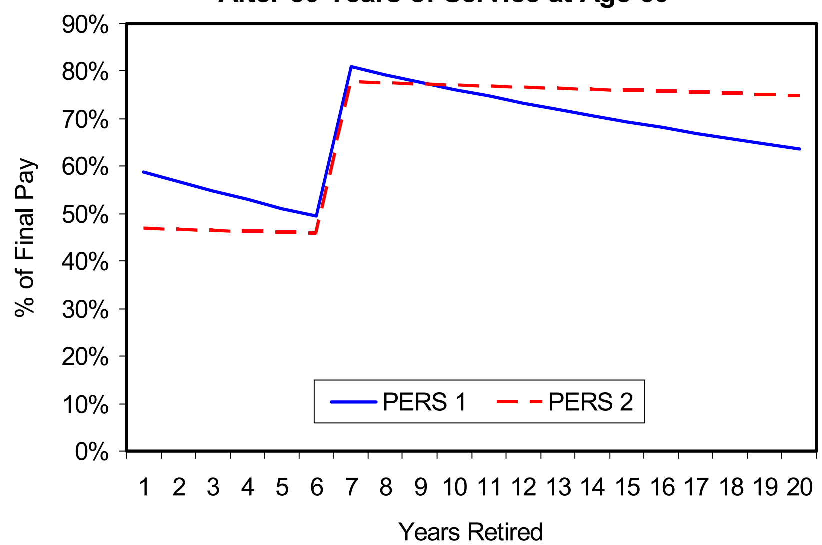
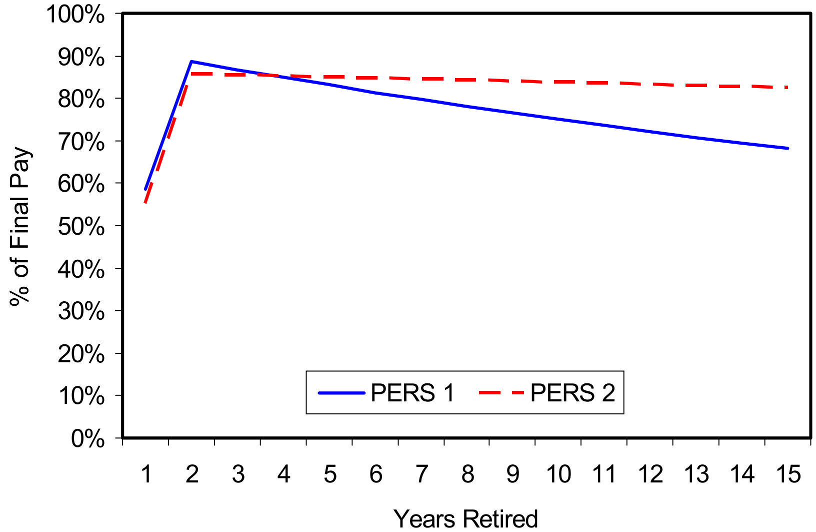


Figure 4
PERS & SSI Benefits as a % of Final Pay
After 30 Years of Service at Age 65



"Golden Handcuffs"

The Plans 2 adopted what is known as a "golden handcuffs" design. This means that they provide relatively little value for employees who leave service prior to retirement and they provide great value to employees who work until age 65. Under this type of design, the most commonly sought way for members with significant years of service to obtain value from this type of retirement plan without remaining in the system until age 65 is to seek a lowering of the retirement age so they can receive an immediate benefit on termination. This can be accomplished through early retirement windows or plan amendments that permanently reduce the retirement age.

In contrast, members of service-based plans commonly seek opportunities to be rehired after retirement. This has been true in Washington state, as Plan 1 members and employers have taken the lead on initiatives to allow post-retirement employment.

Early Retirement

The service-based Plans 1 provided for normal retirement upon the fulfillment of one of the following:

1. five years of service and attainment of age 60;
2. 25 years of service and attainment of age 55; and
3. 30 years of service (at any age).

There are no provisions for early retirement of PERS 1 members, as the Plans 1 are designed to allow normal retirement upon completion of a career.

As discussed in the history section, the Plans 2/3 were designed to discourage early retirement and encourage working until age 65. Originally, the Plans 2 provided for early retirement, but completely at the member's cost. Members could seek early retirement after 20 years of service and attainment of age 55, with the benefit being actuarially reduced from age 65. Later (in 1991) a compromise was added whereby members who worked 30 years (instead of 20) and reached age 55 could qualify for "alternate early retirement." The reduction for alternate early retirement is not completely born by the member, as it involves a 3% per year reduction from age 65 rather than the full actuarially equivalent reduction.

The following table from the Department of Retirement Systems' website shows the approximate effect of the early retirement reductions:

PERS, TRS and SERS Plan 2/3
Early Retirement Reduction Factors

Age at Retirement	20-29 Years of Service Credit, Benefit as % of Age 65 Benefit	30 Years of Service Credit or More, Benefit as % of Age 65 Benefit
55	37%	70%
56	40%	73%
57	43%	76%
58	49%	79%
59	55%	82%
60	61%	85%

Age at Retirement	20-29 Years of Service Credit, Benefit as % of Age 65 Benefit	30 Years of Service Credit or More, Benefit as % of Age 65 Benefit
61	67%	88%
62	73%	91%
63	82%	94%
64	91%	97%
65	100%	100%

Provisions for early and alternate early retirement were carried forward into the design of the Plans 3. As a general matter, the Plan 2/3 members who retire early experience a significantly reduced income replacement ratio for their defined benefit. <u>See</u> Adequacy of Benefits Report to the SCPP, June 2004. Term-vested members of Plan 3 who leave employment early were given additional flexibility to protect their accrued benefit without taking early retirement: Plan 3 members with at least 20 service credit years who separate from service will have their pension benefits increased by 0.25% per month, or approximately 3% for each year they delay receiving benefits until age 65. Also, Plan 3 members can plan for early retirement at their own expense by increasing their member contributions. Conversely, in down markets (assuming they are physically able), Plan 3 members can work past 65 and continue to improve their benefits.

Portability

Portability refers to the ability to maintain the value of retirement benefits earned for past employment when changing jobs prior to retirement. Members of the Plans 2 are discouraged by the plan design from changing careers to new jobs covered by other retirement systems unless those systems are included in Washington's portability statute. The portability statute allows members to combine service credit with that earned in certain other Washington state retirement systems in order to qualify for retirement. Those systems include TRS, PERS, the Statewide City Employees' Retirement System, SERS, the Washington State Patrol Retirement System, Plan 2 of the Law Enforcement Officers' and Firefighters' Retirement System, the city employees' retirement systems for Seattle, Tacoma and Spokane, and staring July 1, 2006, the Public Safety Employees' Retirement System.

The Plans 3 repeat most of the design features of the Plans 2, but add more portability due to the fact that members are immediately vested in the defined contribution portion of their benefit. Thus Plan 3 members can leave prior to vesting, work for any employer, and still receive 100% of the value of their employee contributions plus earnings. Also, as mentioned above, members with 20 service credit years may leave service and have their pension benefits increased 0.25% per month, or approximately 3% for each year they delay receiving benefits until age 65 ("indexed term-vested benefit").

Pension plans may also address portability of benefits by authorizing members to **purchase service credit** for years of work that the individual would otherwise lose. For example, a teacher may work only two years in a state that requires five years of work before the teacher will be eligible, sometime in the future, for a pension. If the teacher moves to another state with a service-based retirement plan that requires 30 years of service to receive a full pension, then at 28 years of service, that teacher could purchase the service credit for the two additional years of teaching in the first state and have the 30 years needed to receive a full pension.

Washington's Teachers' Retirement Plans currently allow members to elect to use service credit earned in an out-of-state retirement systems solely for the purpose of determining the time at which the member may retire. The benefit is actuarially reduced to recognize the difference between the age a member would have first been able to retire based on service in Washington and the member's retirement age. <u>See</u> RCW 41.32.065. Out-of-state service may also be used to meet alternate early retirement requirements, which would result in the use of a 3% per year early retirement reduction factor (ERF) instead of an actuarial ERF.

Example: A member age 55 with 25 years of Washington state service credit and 5 years of out-of-state service credit is assessed 10 years worth of reductions (since he/she needs 10 years to reach age 65). The member can use 5 years of out-of-state service credit to qualify for an alternate early retirement, but the 5 years does not count as membership service for benefit purposes. Instead DRS would use actuarial early retirement reductions for the first 5 of the 10 years and the 3% alternate early retirement reduction for the remaining five years. The effect on the monthly benefit is shown below:

2% x 25 years x $6,500 (AFC) = $3,250
x .61 (% of benefit using actuarial ERF) = $1,982.50
x .85% (% of benefit using 3% ERF) = **$1,685.12**

The out-of-state service-credit-purchase approach to portability has not been incorporated into the PERS and SERS Plans. However in the PERS, SERS and TRS Plans 2/3, service credit purchases can be used to offset other reductions in benefits. See SSB 6251/HB 2535, Ch. 172, Laws of 2004) that was passed to allow these Plan 2/3 members who apply for early retirement to make a one-time purchase of up to five years of additional service credit at actuarial cost. While the service credit is not membership service, it can be used to help offset the benefit reductions for early retirement.

Alternative Approaches Considered Prior to Adoption of the Plans 3

The Joint Committee on Pension Policy studied five approaches to changing the Plans 2 prior to the creation of the Plans 3:

- 1a) lower the normal retirement age, and 1b) reduce early retirement reduction factors;
- 2) increase career mobility and allow limited payments prior to normal retirement;
- 3) allow employees the opportunity to choose their normal retirement age with the employee contribution reflecting the cost of the plan chosen;
- 4) create a new hybrid plan; and
- 5) create a new defined contribution plan.

The first three approaches would modify the existing Plan 2 design. The last two approaches would require new Plans 3.

Approach No. 1A: ***Lower Normal Retirement Age***

The 1992 Report examined the option of lowering the normal retirement ages for the Plans 2 to the Plan 1 retirement ages (age 60 with five years of service, age 55 with 25 years or at any age with 30 years). At that time the option was identified as a "high cost" item that would cause contribution rates to increase substantially. Less costly variations on this proposal were also considered: a 3-year reduction in the normal retirement age and a 5-year reduction. According to surveys conducted at the time, the majority of Plan 2 members expressed a willingness to pay higher employee contribution rates of between 2 and 2.5% in exchange for normal retirement at age 60 instead of 65.

Lowering the normal retirement age, however, was ultimately rejected. The 1992 Report identified two major ways that lowering the normal retirement age would depart from Plan 2 policies:

- retirement benefits would no longer be paid only at an age when employees are generally presumed to permanently leave the workforce; and
- retirees might not receive an adequate initial benefit (due to less service) and the purchasing power of the initial benefits would not be as well protected for the longer retirement period.

*Approach No. 1(B): Significantly **Reduce Early Retirement Reduction Factors***

This approach would have kept the Plan 2 normal retirement age, but lowered the early retirement adjustment factors from a full actuarial adjustment (about 7-9 % per year) to 1% per year. The eligibility criteria for early retirement under this alternative would have stayed the same: age 55 with 20 years of service for PERS and TRS 2. The change would have allowed eligible Plan 2 members to retire up to 10 years prior to the "normal" retirement age without a significant reduction in benefits. The following examples show the impact on the annual pension benefit of the actuarial early reduction factor (ERF) as compared to a 1% ERF:

<u>TRS 2 member retiring at age 55 using actuarial ERF:</u>
Age 65 - 55 = 10 years
63% reduction
$40,000 x 25 years x 2% = $20,000 x .37
Annual Benefit = **$7,400**

<u>TRS 2 member retiring at age 55 using 1% ERF:</u>
Age 65 - 55 = 10 years
10% reduction
$40,000 x 25 years x 2% = $20,000 x .90
Annual Benefit = **$18,000**

Again, this alternative was identified as "high cost" in the 1992 Report. The same two departures from Plans 2 policies were identified for this alternative as for lowering the retirement age: retirement benefits would be paid prior to when employees were expected to permanently leave the workforce, and it would be less certain that the benefit would be adequate to maintain the retiree's standard of living throughout the period of retirement. This alternative was ultimately rejected.

Approach No. 2: ***Increase Career Mobility and Allow Limited Payments Prior to Retirement***

Several options were studied under this approach. The first option was to provide **automatic increases for vested benefits**. Upon separation from covered employment with 20 or more years of service, Plan 2 members who leave their contributions with the system would have their benefit increased each year during the period between termination and retirement. The annual increase would be based on the same formula as the Plan 2 COLA - the change in the Seattle CPI, up to 3% per year. The member would not begin receiving the benefit until the normal retirement age of 65.

The purpose of this benefit was to help ensure that long-service employees who leave covered positions receive a benefit at the normal retirement age that has increased to keep up with inflation. It would reduce the financial penalty incurred by employees who move to positions in the private sector, or other positions not covered by Washington's portability statutes. This benefit was ultimately adopted for the defined benefit component of the Plans 3.

Another alternative under this approach was to **expand the coverage of the portability statute** to include LEOFF 2 and the Seattle, Tacoma and Spokane employee retirement systems. This would make it possible for employees to change jobs to a wider range of public sector positions while maintaining value for their early years of service. These changes were ultimately adopted as amendments to RCW 41.54.010.

Another alternative was studied that would **credit member contributions with interest** at a rate which more closely reflects market rate interest. This would be accomplished by methods such as crediting accounts with the average return earned by medium or long-term government bonds, or the five-year average returns earned by the State Investment Board. The main purpose of this change would be to increase the perceived value of the retirement system for younger employees and to respond to the most frequent active members' complaint at that time. It would also increase the amount of benefits employees might be able to collect early in connection with job transitions as well as the amount such members could withdraw at retirement. Ultimately this alternative was rejected as a Plan 2 modification but was largely incorporated into the Plans 3 as the defined contribution component of these hybrid plans.

An **"optional job/retirement transition benefit"** was considered for Plan 2 members with twenty of more years of service. These members would be paid a monthly income from their accumulated contributions under two circumstances:

1. 50% of pay for up to two years, while training for a new career or on a sabbatical break (job transition benefit); or
2. up to 50% of pay, or the member's accrued benefit, when leaving the work force between age 60 and 65 (retirement transition benefit for PERS and TRS Plans 2 only).

The member would receive a reduced benefit at retirement to reflect the member contributions paid out before normal retirement age. The reduced benefit could be actuarially equivalent or could be partially subsidized. Both benefits would permit a member to receive payment of all or part of their member contributions prior to retirement, without destroying their eligibility for a benefit provided by the employer. The income from this benefit could also "bridge" the period between age 60 and when the retiree receives Social Security. This alternative was not adopted.

A **"phased retirement" benefit** was also considered. Under this proposal, Plan 2 members could work half-time and at the same time collect 50% of their accrued retirement allowance, for up to three years prior to full retirement. The members would have to be age 62 or older and enter into a contract for half-time service with their employers. At full retirement, the member's benefit would be reduced to adjust for payments made prior to the normal retirement age. If a full actuarial reduction were made, there would be no cost to the system. This approach was not adopted.

Finally, the 1992 Report considered allowing those in Plan 2 the option to **withdraw** their **member contributions plus interest at retirement** as had been allowed for members of TRS 1. The retirement allowance would be actuarially reduced to reflect the value of the withdrawn contributions. This alternative was not implemented.

Approach No. 3: ***Allow Employees to Choose Between Three Different Retirement Plans, Each with Benefits Similar to the Plan 2 Systems, Except for Different Normal Retirement Ages***

Under this approach, three new retirement plans would be created that were similar to PERS 2, but each would have a different normal retirement age: Tier 3A - age 65; Tier 3B - age 60; and Tier 3C - age 55. Employees would have the option of selecting which plan they wished to be covered under, but would pay higher contribution rates for service earned under the plans with earlier retirement ages. Benefits would be portable, and employees would be given frequent opportunities to move between the different plans. This approach was rejected. Like the alternatives in Approach No. 1, this approach would depart from Plan 2 policies in that retirement benefits would no longer be paid only at an age when employees were generally presumed to permanently leave the workforce, retirees who elected the age 55 plan may not receive an adequate initial benefit (due to service), and the purchasing power of the initial benefit would not be as well-protected for the longer retirement period.

Approach No. 4: ***Replace the Plan 2 Systems with New "Split Plans"*** *which Reflect Typical Private Sector Federal Employees Retirement System Plan Design.*

This approach involved creating a new retirement system which would include both a defined benefit pension and a defined contribution account. The design would provide a balance between the policy goals promoted by defined benefit plans and defined contribution plans. The hybrid plan model was ultimately adopted for the Plans 3.

Approach No. 5: ***Replace Plan 2 Systems with Defined Contribution Plan***

This approach would provide a source of retirement savings which would be highly portable for employees who switched jobs prior to normal retirement age. However employees would take on the risk of poor investment returns, and employees who provided identical periods of service would receive different retirement benefits. In other words, this approach was deemed more flexible, but riskier. The responsibility for the long-term financial security would be shifted largely to the retiree. Management of risks associated with longevity (i.e., the danger of outliving one's benefit) would also shift to the retiree. The 1992 Report indicated that for a given level of funding, retirees would receive smaller benefits in a defined contribution plan than under the defined benefit design. Employer contribution rates, however, would be stable and predictable. This approach was not adopted.

In summary, the Joint Committee on Pension Policy studied many alternatives to the Plan 2 design prior to recommending the creation of the Plans 3. Despite the fact that employees had identified the Plan 2 retirement age as one of their top concerns, the designs of the Plans 2 and 3 retained the primary policy of withholding the retirement pension until the age at which the member is presumed to permanently leave the workforce - that is, age 65. Lowering the normal retirement age would depart from that established policy.

Estimated Cost of Lowering the Normal Retirement Age in the Plans 2/3

Lowering the normal retirement age in the Plans 2/3 will impact the required actuarial contribution rates as shown below. As a result of higher contribution rates, increases in funding expenditures are also projected.

Estimated Cost of Lowering Retirement Age from 65 to 60

	PERS	**SERS**	**TRS**	**Total**
Increase in Contribution Rates				
Employee *(Plan 2 Only)*	2.71%	2.85%	2.85%	
Employer	2.71%	2.85%	2.85%	
Costs (in millions):				
2005-2007 Biennium				
State:				
General Fund	$ 82.5	$ 40.2	$ 174.0	$ 296.7
Non-General Fund	136.3	0.0	0.0	136.3
Total State	**$ 218.8**	**$ 40.2**	**$ 174.0**	**$ 433.0**
Local Government	194.0	35.6	35.7	265.3
Total Employer	412.8	75.8	209.7	698.3
Employee	$ 382.0	$ 19.5	$ 9.2	$ 410.7
2005-2030 25 Years				
State:				
General Fund	$ 2,322.6	$ 1,191.4	$ 4,734.0	$ 8,248.0
Non-General Fund	3,832.5	0.0	0.0	3,832.5
Total State	**$ 6,155.1**	**$ 1,191.4**	**$ 4,734.0**	**$ 12,080.5**
Local Government	5,458.4	1,055.5	969.8	7,483.7
Total Employer	11,613.5	2,246.9	5,703.8	19,564.2
Employee	$ 11,517.8	$ 112.8	$ 23.3	$ 11,653.9

Estimated Cost of Lowering Retirement Age from 65 to 62

	PERS	SERS	TRS	Total
Increase in Contribution Rates				
Employee *(Plan 2 Only)*	1.70%	1.64%	1.53%	
Employer	1.70%	1.64%	1.53%	
Costs (in millions):				
2005-2007 Biennium				
State:				
General Fund	$ 51.8	$ 23.2	$ 93.4	$ 168.4
Non-General Fund	85.4	0.0	0.0	85.4
Total State	**$ 137.2**	**$ 23.2**	**$ 93.4**	**$ 253.8**
Local Government	121.6	20.6	19.1	161.3
Total Employer	258.8	43.8	112.5	415.1
Employee	$ 239.6	$ 11.3	$ 4.9	$ 255.8
2005-2030 25 Years				
State:				
General Fund	$ 1,457.0	$ 685.9	$ 2,541.5	$ 4,684.4
Non-General Fund	2,404.2	0.0	0.0	2,404.2
Total State	**$ 3,861.2**	**$ 685.9**	**$ 2,541.5**	**$ 7,088.6**
Local Government	3,424.3	608.5	520.2	4,553.0
Total Employer	7,285.5	1,294.4	3,061.7	11,641.6
Employee	$ 7,224.7	$ 64.8	$ 12.3	$ 7,301.8

Funding Policies of the Plans 2/3

Reducing the normal retirement age for the Plans 2/3 may have implications for the funding policies of the plans. With respect to **cost-sharing**, current funding policy presumes that costs should be shared equally between employers and employees. See Joint Committee on Pension Policy proposed polices for new Plan 3, September 1993. As shown in the previous section of this report, reducing the normal retirement age is a high-cost proposition. Thus, in order to facilitate enactment of such a proposal, there may be some need to adjust the policy to accommodate the increased cost. For example the SCPP has seen at least one proposal that would increase the Plan 3 employee contribution rate to pay for increased benefits.

The other significant funding policy implication relates to liability for benefits payable as the result of past service. By lowering the retirement age, **liabilities for past-service benefits are increased** due to the fact that their cost cannot be recovered over as long of a period of time. As provided in the actuarial funding chapter, Chapter 41.45 RCW, all benefits for Plan 2 and 3 members are to be funded over the working lives of those members and paid by the taxpayers who receive the benefits of those members' services. See RCW 41.45.010(4). For those members who have worked part of their careers, the benefits they have already earned must be paid for over the remainder of their careers. If the length of these careers is shortened due to the creation of a lower normal retirement age, liabilities are increased at the same time that the period to collect the funds to pay for the benefit improvement is shortened (a "double whammy").

Proposals Affecting Retirement Eligibility

Many proposals have been made to the SCPP for study during the 2004 interim. Because some of them specifically affect retirement eligibility, they may be viewed as alternatives or companions to options for reducing the normal retirement age. Estimated costs for these proposals are not provided as part of this initial report. The proposals include:

- Normal retirement with an age/service combination of 85 (rule of 85).
- Normal retirement at any age with 35 or 30 years of service.
- Eliminating the actuarial reduction factors for early retirement and replacing them with a uniform 3% per year reduction factor.
- Increasing the Plan 3 defined benefit from 1% to 1.5% to address adequacy concerns.
- Changing the Plan 3 vesting period from 10 to 5 years.
- Eliminating the early retirement reduction factor for permanent disability.
- Expanding the indexed term-vested benefit (currently 3% per year for Plan 3 members with 20 years of service credit).
- Providing for the purchase of up to 10 years of service credit for teaching in American public schools (state and federal) using a cost formula that is less than actuarial cost.
- Merging Plans 2 and 3 into a new plan.

If, as the result of this background briefing, the SCPP decides to pursue options related to normal retirement eligibility within the Plans 2/3, the above proposals may be viewed as possible options for further discussion that may be added to the most obvious options of reducing the normal retirement age from 65 to some lower age (e.g. 62 or 60).

Conclusion

Service-based plans usually result in earlier retirements, higher costs, and pressures to allow post-retirement employment. Age-based plans usually result in later retirement ages, lower costs, and pressures to allow retirement at earlier ages. Washington started with service or career-based plans and moved to age-based plans in 1977 in order to reduce costs. Lowering the normal retirement age would be consistent with national trends and would help address long-standing employer and employee concerns with the retirement age.

Lowering the normal retirement age would also be a departure from the policy that is currently the cornerstone of the Plans 2/3 - that is, to provide a retirement benefit when the member is presumed to have permanently left the workforce and that is at or near the age when Social Security and Medicare will pick up a significant portion of retiree costs. Lowering the normal retirement age in the Plans 2/3 would move toward a retirement philosophy that is more career-based than age-based, and would result in significantly increased costs.

Age 65 Retirement

Laura C. Harper
Senior Research Analyst/Legal

Select Committee on Pension Policy
September 7, 2004

Purpose of Initial Report

- Many proposals affecting retirement eligibility are before the SCPP.
- This report is intended as background information (i.e. how did we get here).
- Focus is on history, plan design and existing retirement policy.
- Cost estimates are provided on lowering retirement age in Plans 2/3.

What is retirement?

- Completion of career or permanently leaving the workforce?
- Plans 1: “service-based” or “career-based”.
- Plans 2/3 – “age-based”.

Service-Based Plans

- Plans 1 are the example.

- Plans 1 are characterized by:

  – higher costs
  – earlier retirements
  – pressure to allow post-retirement employment

Age-Based Plans

- Plans 2/3 are the example.

- Plans 2/3 are characterized by:

  – later retirement ages
  – lower costs
  – pressures to allow retirement at earlier ages

Washington

- Retirement philosophy changed in 1977 with creation of Plans 2.
- Same basic philosophy continues in the Plans 3.
- Why the change from career-based to age-based retirement?

Cost as a Policy-Driver

- Plans 2 created to address 3 concerns:

  1. Increasing costs of the Plan 1 systems.
  2. Increasing pressure for cost-of-living adjustments (COLAs) in TRS and PERS.
  3. High cost of disability retirements in LEOFF Plan 1.

Plan 2 Savings

- Projected savings in 1977 were $15.9 billion over a 25-year period.
- Benefits would be paid over a shorter period of time.
- Social Security and Medicare would augment benefits more quickly.

Why age 65?

- Tied to Social Security's "full" retirement age of 65.

- Social Security's "full" retirement age is increasing.

  – For those born in 1960 and later, full retirement age is 67.

Plan 2/3 Trade-offs

- Work longer.
- Get automatic cost-of-living adjustment (COLA).
- No 60% cap on average final compensation (AFC).

“Golden Handcuffs” Design

- Provides little value to employees who leave service prior to normal retirement.

- Provides great value to employees who work until or beyond full retirement.

Approach to Early Retirement

Plans 2/3 discourage early retirement by reducing benefits.

– Early retirement: actuarial reduction of benefit .
– Alternate early retirement: 3% per year reduction of benefit.

Design Creates Pressure

- According to 1992 Retirement Age Report, retirement age was one of the top four concerns with Plan 2 design.
- Members and employers have expressed concern.
- At SCPP orientation, “working until age 65” was the number three priority of the group.

National Trend

- According to Ron Snell of the National Conference of State Legislatures (NCSL), the trend for more than 20 years has been to <u>reduce</u> normal retirement ages.

Age 65 to Age 60 – Estimated Effect on Contribution Rates

Increase in Contribution Rates

	PERS	SERS	TRS
Employee *(Plan 2 only)*	2.71%	2.85%	2.85%
Employer	2.71%	2.85%	2.85%

Age 65 to 60 – Estimated Total Employer Costs in Millions

For the 2005 – 2007 Biennium:

Increase in Projected Funding Expenditures

PERS	SERS	TRS	Total
$ 412.8	$ 75.8	$ 209.7	$ 698.3

Age 65 to 60 – Estimated Total Employer Costs in Millions

For 25 years, 2005-2030:

Increase in Projected Funding Expenditures

PERS	SERS	TRS	Total
$11,614	$2,247	$5,704	$19,565

Funding Policies of Plans 2/3

- Cost-sharing
  - Presumption of sharing costs equally between employers and employees.
  - Adjust policy to provide funding?
  - Willingness to pay more for higher benefits?

Funding Policy Implications

- Increasing liabilities for past-service benefits as a “double whammy.”
  - Lowering retirement age increases liabilities.
  - At the same time, the period for paying off liabilities for benefits already earned would be shortened.

Other proposals

- Lower retirement age to 62.
- Rule of 90, 85 or 80.
- 30 or 35 years and out.
- Actuarial reduction factors for early retirement changed to uniform 3% per year.

Other Proposals, cont'd.

- Increase defined benefit formula in Plan 3.
- Reduce the Plan 3 vesting period.
- Eliminate early retirement reduction factors for permanent disability.
- Expand the indexed term-vested benefit.

Other Proposals, cont’d.

- Create a new retirement plan by merging the Plans 2/3 into a new plan.
- Increase service credit purchase opportunities.

1992 Plan 2 Retirement Age Report

- Provides history behind creation of Plans 2.
- Evaluates alternatives to normal retirement age of 65.

Plans 3

- Plans 3 kept the age-based retirement philosophy.

- Added more portability, flexibility and personal responsibility.

- Time will tell if adequacy is compromised.

Changing Plan Design

- Changes in plan design involve trade-offs.
- Washington made a significant change in plan design in 1977.
- Plan design was re-evaluated again in 1993 prior to creation of the Plans 3 in 1995-2002.

Changing Plan Design

- How often?
  - Administrative impacts
  - Potential inequities
  - Funding policy impacts

Changing Plan Design

- In what manner?
  - Systematic large-scale reworking of plan design and plan philosophy?
  - Incremental changes resulting in gradual shift in plan design and plan philosophy?

Summary

- What is retirement?
- If it is a benefit earned upon completion of a career look toward:
  - service-based retirement
  - higher costs
  - pressures for post-retirement employment opportunities

Summary

- If it is a benefit paid when the employee is presumed to leave the workforce, look for:
  - age-based retirement
  - lower costs
  - pressures to lower the retirement age

Conclusion

- Washington adopted “age-based” retirement philosophy and design in 1977.

- Significant costs are associated with returning to a “career-based” retirement philosophy and design.

PFC Subgroup Report

(September 3, 2004)

The PFC subgroup of the SCPP met in Olympia, Washington on August 31, 2004.

Subgroup members attending:

Senator Fraser
Representative Conway
Representative Fromhold
Leland Goeke
Glenn Olson
J. Pat Thompson

Meeting Summary

Representative Conway called the meeting to order and discussed the purpose of the subgroup meeting was to formulate a recommendation to the full SCPP concerning the adoption of employer and plan 2 member contribution rates for the 2005-07 biennium. Matt Smith, State Actuary, reviewed SCPP and PFC background materials related to the subgroup's agenda.

The subgroup discussed the preliminary 2005-07 contribution rates presented by the State Actuary and reviewed the preliminary actuarial audit report presented to the PFC by Milliman U.S.A. on August 31, 2004. The report found that the actuarial work performed by the Office of the State Actuary (OSA) was reasonable and appropriate, the total liabilities calculated by Milliman matched closely to the liabilities calculated by the OSA, and the resulting contribution rates calculated by the OSA for the 2005-07 biennium are accurate.

The subgroup discussed the impact of funding the liability for future gain-sharing benefits. As reported by the State Actuary and verified in the actuarial audit, future gain-sharing benefits represent a material liability to the affected retirement systems and were excluded from previous actuarial valuations performed by the OSA. Subgroup members that attended the earlier PFC meeting discussed that the Office of Financial Management (OFM) was not aware of the fiscal impact of recognizing the liability of future gain-sharing benefits and that the additional $176 million GF-S impact was not included in preliminary OFM budget documents for the 2005-07 biennium.

The subgroup then discussed a proposal presented by Member Olson to defer or phase-in projected rate increases over a 6-year period. Representative Conway proposed that a deferred rate increase proposal could be combined with a permanent contribution rate floor. The subgroup members directed the State Actuary to prepare a deferred rate increase proposal for the September 7, 2004 Executive Committee meeting of the SCPP.

Subgroup Recommendations

Recommendation to the PFC

Adopt the preliminary 2005-07 contribution rates, as calculated by the State Actuary, including the cost of recognizing the liability associated with future gain-sharing benefits.

Recommendation to the SCPP

Develop a legislative proposal that would defer or phase-in projected employer and plan 2 member rate increases over the next 3 biennia. Proposal should include a permanent contribution rate floor after the 6-year phase-in period is completed.

Burkhart, Kelly

From:	Smith, Matt
Sent:	Thursday, September 02, 2004 1:07 PM
To:	Burkhart, Kelly
Cc:	Winner, Charlene; Granger, Sandra
Subject:	FW: Draft actuarial audit report

pfc0011njc.doc (246 KB)   pfc0011njc.pdf (434 KB)

For our SCPP meeting file.

-----Original Message-----
From: johnc@drs.wa.gov [mailto:johnc@drs.wa.gov]
Sent: Thursday, September 02, 2004 10:31 AM
To: Fraser, Sen. Karen; Conway, Rep. Steve
Cc: Smith, Matt
Subject: Draft actuarial audit report

SCPP Chair Fraser and Vice-Chair Conway,

> The attached draft actuarial audit report from Milliman Consultants and
> Actuaries was presented to the Pension Funding Council at their August 31,
> 2004 meeting. The report summarizes the results of a detailed review of
> the Office of the State Actuary. The report is attached as a Word
> document and PDF file. If you are unable to open either attachment,
> please let me know and I will mail a copy to you.
>
> John Charles, Chair
Pension Funding Council
> (360) 664-7312
> johnc@drs.wa.gov
>
> <<pfc0011njc.doc>> <<pfc0011njc.pdf>>
>

Pension Funding Council

Actuarial Audit Report

Prepared for August 31, 2004
Board Meeting

Prepared by:

Karen I. Steffen, F.S.A., E.A., M.A.A.A.
Consulting Actuary

Nick J. Collier, A.S.A., E.A., M.A.A.A.
Associate Actuary

Daniel R. Wade, A.S.A., E.A., M.A.A.A.
Associate Actuary

August 31, 2004

Pension Funding Council
c/o Ms. Jane Sakson
Office of Financial Management
P.O. Box 43113
Olympia, WA 98504-3113

Dear Ms. Sakson:

The enclosed report presents the findings and comments resulting from a detailed review of the actuarial valuation performed by the Office of the State Actuary (OSA). An overview of our major findings is included in the Executive Summary section of the report. More detailed commentary on our review process is included in the latter sections.

In preparing this report, we relied, without audit, on information (some oral and some in writing) supplied by the OSA staff and the Department of Retirement Systems (DRS). This information includes, but is not limited to, statutory provisions, employee data and financial information. In our examination of these data, we have found them to be reasonably consistent and comparable with data reported and used for other purposes. It should be noted that if any data or other information provided to us is inaccurate or incomplete, our calculations and recommendations may need to be revised.

On the basis of the foregoing, we hereby certify that, to the best of our knowledge and belief, this report is complete and accurate and has been prepared in accordance with generally recognized and accepted actuarial principles and practices which are consistent with the principles prescribed by the Actuarial Standards Board (ASB) and the Code of Professional Conduct and Qualification Standards for Public Statements of Actuarial Opinion of the American Academy of Actuaries.

Any distribution of the enclosed report must be in its entirety including this cover letter, unless prior written consent is obtained from Milliman, Inc.

We would like to express our appreciation to both the OSA and DRS staff for their complete and timely cooperation in supplying the data on which this report is based.

I, Karen I. Steffen, am a member of the American Academy of Actuaries and a Fellow of the Society of Actuaries, and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

I, Nick J. Collier, am a member of the American Academy of Actuaries and an Associate of the Society of Actuaries, and meet the Qualification Standards of the American Academy of Actuaries to render the actuarial opinion contained herein.

We respectfully submit the following report, and we look forward to discussing it with you and the Pension Funding Council.

Sincerely,

Karen I. Steffen, F.S.A., M.A.A.A.
Consulting Actuary

Nick J. Collier, A.S.A., M.A.A.A.
Associate Actuary

KIS/NJC/nlo

Draft

Table of Contents

Draft

Section 1
Executive Summary

Purpose and Scope of the Actuarial Audit

This actuarial audit reviews the September 30, 2003 actuarial valuations performed by the Office of the State Actuary (OSA) which set the contribution rates for adoption by the Pension Funding Council. The purpose of the audit is to determine if the methodology used by the OSA is reasonable and that the contribution rates are calculated appropriately.

As requested, the following tasks were performed in this audit:

- ✓ Liability calculations were checked by performing a full independent parallel valuation.
- ✓ The use of assets values was reviewed.
- ✓ The calculation of contribution rates was validated.

The following plans are included in this audit. Note that LEOFF Plan 2 has a separate retirement Board; therefore, a separate audit and report are being completed for this plan.

- PERS Plans 1, 2 & 3
- TRS Plans 1, 2 & 3
- SERS Plans 2 & 3
- LEOFF Plan 1
- WSP Plans 1 & 2

Statement of Key Findings

Based upon our review of the September 30, 2003 actuarial valuation, we found the actuarial work we reviewed was reasonable and appropriate. The resulting contribution rates for the 2005-2007 biennium reasonably reflect the actuarial assets and liabilities.

Our conclusions concerning the primary issues of this review are as follows:

- ❑ **Qualifications:** The September 30, 2003 actuarial valuations for the State of Washington retirement systems were performed by a qualified actuary and is in accordance with the principles and practices prescribed by the Actuarial Standards Board.

- ❑ **Membership Data:** We performed tests on the raw data and the valuation data. Based on this review, we feel the data used in the valuation is appropriate.

- ❑ **Actuarial Value of Assets:** We have confirmed that the actuarial value of the assets calculated for the September 30, 2003 valuation is accurate based on the information provided to us. We also find the methodology to be reasonable and in compliance with actuarial standards of practice, although the current method is uncommon.

- **Actuarial Liabilities:** We independently calculated the total liabilities of the Washington State retirement systems. We found that the benefit provisions of all plans were accounted for in an accurate manner, the actuarial assumptions and methods are being applied correctly, and that our total liabilities matched those calculated by the OSA within a reasonable level of tolerance.

- **Funding:** We reviewed the application of the funding method and find it is reasonable and that it meets generally accepted actuarial standards. Based on the systems' funding methods and assumptions, we believe the contribution rates are accurately calculated.

- **Assumptions:** The review of actuarial assumptions is beyond the scope of this audit. The current set of assumptions was reviewed two years ago. At that time, we concluded that the assumptions were "reasonable and appropriate" to use in the actuarial valuation.

- **Gain-Sharing:** The OSA uses a reduction in the expected investment return to account for the estimated value of future gain-sharing payments. We agree that this is an appropriate method to value gain-sharing. We also found that the reduction amount (0.40%) used by the OSA is reasonable.

- **OSA Valuation Report:** The formal report will not be issued until after the completion of the audit, so a review of the report is not included in this audit. However, we would note that in looking at the 2002 valuation report, there was a definite improvement in form and content over the prior report.

- **Recommendations & Considerations:** We are not recommending any changes at this time. There is one area where a change might be considered in the future.

  - ✓ **Assets:** The OSA is in an unusual situation compared to most other actuaries in that the financial and asset information must be first compiled by their staff before an analysis for actuarial valuation purposes can be performed. This is because the audited financial statements are as of June 30; whereas the valuation date is as of September 30. We realize there are reasons for the current procedures, however, it would be preferable to have audited financial statements consistent with the valuation date.

Draft

Section 2
Qualifications

Audit Conclusion

The September 30, 2003 actuarial valuation for the Washington State retirement systems was performed by a qualified actuary and is in accordance with the principles and practices prescribed by the Actuarial Standards Board.

Comments

Qualifications

The actuarial valuation was performed by the State Actuary, Mr. Matthew Smith, with assistance from his staff. We believe Mr. Smith is qualified to perform the actuarial valuation.

Under the qualification standards issued by the American Academy of Actuaries, an actuary must meet each of the following three requirements to be qualified to render a prescribed statement of actuarial opinion:

- ✓ **Basic Education**: Mr. Smith has completed the examinations offered by the Joint Board for the Enrollment of Actuaries and is an enrolled actuary under ERISA. This satisfies this requirement.
- ✓ **Experience**: Mr. Smith is experienced in performing pension valuations. In particular, he has experience working with public-sector retirement systems. This satisfies this requirement.
- ✓ **Continuing Education**: Mr. Smith is an enrolled actuary under ERISA. As such, he must meet minimum continuing education requirements to maintain this designation. This continuing education satisfies this requirement.

Actuarial Standards of Practice

We compared the work performed in the valuation with the Actuarial Standards of Practice (ASOP) prescribed by the Actuarial Standards Board. In particular, we confirmed that the work conforms to the ASB's Code of Professional Conduct and the relevant ASOPs:

- ✓ ASOP #4: *Measuring Pension Obligations* – We believe that the OSA's work is consistent with this standard.
- ✓ ASOP #27: *Selection of Economic Assumptions for Measuring Pension Obligations* – The purpose of this audit was not to review the assumptions. However, based on our prior audit performed two years ago, we believe that the work is consistent with this standard.
- ✓ ASOP #35: *Selection of Demographic and Other Non-Economic Assumptions for Measuring Pension Obligations* – The purpose of this audit was not to review the

assumptions. However, based on our prior audit performed two years ago, we believe that the work is consistent with this standard.

✓ ASOP #XX (Currently in draft form): *Selection of Asset Valuation Methods for Pension Valuations* – We believe that the OSA's work is consistent with this standard.

Section 3
Membership Data

Audit Conclusion

We performed tests on the raw data and the valuation data. Based on this review, we feel the data used in the valuation is appropriate.

Comments

Overall, the data process appears to be thorough and accurate. We would add the following comments:

- **Raw Data:** DRS provide us with the same data that was supplied to the OSA for use in the actuarial valuation.
  - ✓ **Completeness**: The data was quite comprehensive and contained all necessary fields to perform the actuarial valuation.
  - ✓ **Quality**: We compared the DRS data to information from actual benefit calculations for sample members. We found the data to be consistent.

- **Editing:** The OSA staff performs extensive editing on the data. These steps are well documented by the staff. We feel the editing process is reasonable and appropriate, and we found it consistent with our process.

- **Grouping:** Members with similar characteristics are combined during the active data processing (retiree data is not combined). This is an acceptable approach, used by other actuaries dealing with large amounts of data. The grouping approach significantly reduces the number of records processed in the valuation; the result is a large reduction in the time required to run the valuation.

  The only possible drawback is that some characteristics of a specific individual may be lost. For example, the OSA does not identify members with dual service. However, for this valuation, we do not believe there is a material loss of accuracy due to this approach. Given the short turnaround that is sometimes required for legislative analysis, the OSA's preference is to retain the grouping approach. We agree that this is reasonable.

- **Parallel Data Processing:** We performed independent edits on the raw data and then compared our results with the valuation data used by OSA. Although our editing process was not as extensive as that performed by OSA staff for this valuation, we found our results to be very consistent. A summary of all plans in aggregate is shown in Exhibit 3-1. Note that the "Milliman" column reflects the DRS data after adjustments by Milliman. The "OSA" column reflects the actual data used in the OSA valuation. A detailed analysis by plan is shown in Appendix A.

The data processing performed by the OSA staff appears to be thorough and accurate. We do not recommend any changes to the current procedures.

Exhibit 3-1
Member Statistics

	OSA	Milliman	Ratio OSA / Milliman
Active Members			
Number	271,909	271,904	100.0%
Total Salary (Millions)	$11,559	$11,541	100.2%
Average Age	45.6	45.6	100.0%
Average Service	10.3	10.3	100.0%
Average Salary	$42,512	$42,446	100.2%
Terminated Members			
Number Vested	30,155	30,150	100.0%
Number Non-Vested	94,659	94,659	100.0%
Retirees			
Number	110,390	110,435	100.0%
Average Monthly Benefit	$1,385	$1,385	100.0%

Section 4
Actuarial Value of Assets

Audit Conclusion

We have confirmed that the actuarial value of the assets calculated for the September 30, 2003 valuation is accurate. We also found the methodology to be reasonable and in compliance with actuarial standards of practice, although the current method is uncommon.

Comments

We reviewed each of the worksheets and emails that supplied the asset information to the OSA staff and then followed the procedures used to calculate the market value of assets for each plan as of September 30, 2003. The OSA uses the market values and the actuarial asset method to determine the actuarial value of the assets which is then used to determine both the funding status of each plan and the proposed contribution rates.

Like many retirement systems, Washington State uses an actuarial value of assets different from market value in order to smooth the effects of short-term volatility in market value. What makes the current method rather uncommon is that the smoothing period varies based on the market rate of return. The following schedule is used to determine the smoothing period:

	Annual Gain/Loss	
Rate of Return	Smoothing Period	Annual Recognition
15% and up	8 years	12.50%
14-15%	7 years	14.29%
13-14%	6 years	16.67%
12-13%	5 years	20.00%
11-12%	4 years	25.00%
10-11%	3 years	33.33%
9-10%	2 years	50.00%
7-9%	1 year	100.00%
6-7%	2 years	50.00%
5-6%	3 years	33.33%
4-5%	4 years	25.00%
3-4%	5 years	20.00%
2-3%	6 years	16.67%
1-2%	7 years	14.29%
1% and lower	8 years	12.50%

Draft

Please note that the expected rate of return is 8%. The more that the actual return deviates from the expected return, the longer the smoothing period and the longer before the gain or loss is fully recognized in the actuarial value of assets. Due to the symmetry about the expected return on assets, the method does not systematically bias toward understatement or overstatement relative to market value. The lack of bias is essential for compliance with the proposed actuarial standards of practice governing the valuation of assets.

From October 1, 2002 through September 30, 2003, the assets for most plans had a market value rate of return of just over 15%, and thus these gains are amortized over eight years in compliance with the above schedule. Note that the two most mature plans (PERS 1 and TRS 1) had returns for the year of just under 15%, and these gains are being amortized over seven years. The previous year had a market value return of less than 1% for all plans, and that loss is being amortized over eight years.

When a smoothing method is applied, the actuarial value of assets will deviate from the market value of assets. Many systems apply a corridor; that is, the actuarial value of assets is not allowed to deviate from the market value by more than a certain percentage. The purpose of a corridor is to keep the actuarial value of assets within a reasonable range of the market value. The current asset method has a corridor of 30%. Since the actuarial value and market value are within 30% of each other, the corridor does not currently apply. We agree that using a corridor is appropriate, although we would note that a corridor of 20% is more commonly used.

The OSA is in an unusual situation compared to most other actuaries in that the financial and asset information must be first compiled by their staff before an analysis for actuarial valuation purposes can be performed. This is because the audited financial statements are as of June 30; whereas the valuation is as of September 30.

The OSA had difficulties in the past in gathering the asset data and computing consistent rates of return on the investments compared to those that are reported by the SIB. Therefore, their procedure for determining the asset gain or loss for each valuation period is based on the cash flow of the funds in the SIB and the rate of return the SIB calculates on this basis. The OSA then used those calculations to compute the expected returns at the assumed 8.0% valuation rate and the difference is the gain or loss. Again, this is somewhat unusual, but we feel it is quite reasonable given the information available. However, it can lead to small differences in the rates of return than if full asset information were used (i.e., if items not currently held by SIB, such as payables reported by DRS and assets held by Treasury, were included). Since the smoothing period is dependent on the rate of return, small changes in timing may have a larger impact on the calculated actuarial value of assets.

We have confirmed that the actuarial value of the assets calculated for the September 30, 2003 valuations was accurate and reasonable, based on the comments stated above.

Section 5
Actuarial Liabilities

Audit Conclusion

We independently calculated the total liabilities of the Washington State retirement systems. We found that the benefit provisions of all plans were accounted for in an accurate manner, the actuarial assumptions and methods are being applied correctly, and that our total liabilities matched those calculated by the OSA within a reasonable level of tolerance.

Comments

We independently calculated the liabilities for all members based on the following:

- ✓ **Data** – We used the same valuation data used by the OSA. As discussed in Section 3, we first confirmed that this data was consistent with the data provided by DRS.
- ✓ **Assumptions** – We used the assumptions disclosed in the 2002 actuarial valuation report.
- ✓ **Methods** – We used the actuarial methods disclosed in the 2002 actuarial valuation report.
- ✓ **Sample Lives** – The OSA provided us with detailed calculations for a number of individuals that are produced by their valuation system. This allowed us to analyze the components of the calculations for each benefit type (withdrawal, service retirement, disability, etc.) and verify that the assumptions and methods were being applied correctly.
- ✓ **Benefits** – We incorporated the benefits for all plans into our valuation system. We obtained this information from the member handbooks and the relevant law.

During our work, we noticed a few minor issues with the liability calculations. We discussed these with the OSA, and they incorporated our recommendation in their valuation. None of the resulting changes were material.

We did a detailed comparison by plan and type of benefit for the liabilities computed in our parallel valuation with those calculated by the OSA. Exhibit 5-1 shows a summary of this analysis for the two parallel valuations. The total liabilities are within approximately 1% for all plans. (Note that there will always be differences in liabilities when different software is used.) A more detailed comparison is shown in Appendix B. Based on these results, we feel that the OSA staff is valuing all provisions in an accurate manner.

Draft

Exhibit 5-1
Comparison of Liabilities
(Dollar Amounts in Millions)

Present Value of Fully Projected Benefits*

Plan	OSA	Milliman	OSA / Milliman Ratio
PERS 1	$ 13,219	$ 13,318	99.3%
PERS 2 & 3	14,278	14,188	100.6%
TRS 1	10,767	10,769	100.0%
TRS 2 & 3	5,220	5,280	98.9%
SERS 2 & 3	2,137	2,132	100.3%
LEOFF 1	4,341	4,326	100.3%
WSP 1	722	725	99.5%
WSP 2	5	5	100.0%
All Members	**$ 50,690**	**$ 50,744**	**99.9%**

Present Value of Future Salaries

Plan	OSA	Milliman	OSA / Milliman Ratio
PERS 1	$ 4,224	$ 4,062	104.0%
PERS 2 & 3	58,979	59,149	99.7%
TRS 1	2,996	3,122	96.0%
TRS 2 & 3	33,689	33,438	100.7%
SERS 2 & 3	10,274	10,153	101.2%
LEOFF 1	234	234	100.1%
WSP 1	757	755	100.2%
WSP 2	31	31	100.0%
All Members	**$ 111,184**	**$ 110,945**	**100.2%**

** Reflects the estimated value of future gain-sharing benefits.*

Section 6
Funding

Audit Conclusion

We reviewed the application of the funding method and find it is reasonable and that it meets generally accepted actuarial standards. Based on the system's funding methods and assumptions, we believe the contribution rates are accurately calculated.

Comments

Contribution Rates

Our key findings on the calculated contribution rates are:

- ✓ Based on the assets and liabilities, we found the contribution rates calculated by OSA, effective for the 2005-07 biennium (if adopted), to be accurate:

System	Employer	Plan 2 Member
▪ PERS	5.73%	3.38%
▪ TRS	6.74%	2.48%
▪ SERS	7.56%	3.51%
▪ LEOFF 1	0.00%	N/A
▪ WSP	4.51%	4.51%

- ✓ They finance the system's liabilities using a modified aggregate cost method which funds benefits over the working lifetime of the current members in a reasonable fashion.
- ✓ They follow state law.
- ✓ They include the value of future potential gain-sharing benefits.

Different contribution rates are calculated for each system. The employer contribution rates within each system are level for members of all plans within a system.

We reviewed the calculation of each System's contribution rates provided by OSA. We first verified that the liabilities generated by the OSA valuation system were properly input into the calculation worksheet, including the actuarial and market values of the assets. We then reviewed the methodology used to determine the contribution rates. We found that the funding formulas were appropriate, and the final contribution rates were calculated correctly.

The following provides comments on some of the funding aspects of the Washington State retirement systems.

State Law: The calculation of the contribution rates is consistent with the actuarial funding of the State Retirement Systems mandated in Chapter 41.45 of the RCW.

Key details include:

- The OSA calculates employer (and state) contribution rates which are the level percent of pay needed to:
  - ✓ Fully amortize the total costs for PERS, TRS, and LEOFF Plan 1 by June 30, 2024
  - ✓ Continue to fully fund plans 2 & 3 for PERS, TRS, SERS and Plans 1 & 2 for WSP
- The aggregate actuarial cost method is used to calculate the combined Plans 2 & 3 employer contribution rates for PERS, TRS, & SERS. For WSP, Plans 1 & 2 are combined.
- The PERS, TRS & SERS Plan 2 member rates will not increase as a result of gain sharing amounts distributed to Plan 3 members.

Washington State Cost Method: The cost method creates level employer contribution rates for each plan in PERS, TRS, & LEOFF. This is designed to pay off the unfunded liabilities of the closed-off Plan 1 for each system. A non-standard variation of the aggregate cost method is used to achieve this goal. Contribution rates are determined as follows:

1. The normal cost rate is calculated as the level percent of all future plan 2 & 3 salaries required to finance:
   (a) the present value of the combined plan 2 & 3 benefits for current members
   (b) less the combined plan 2 & 3 actuarial assets.

2. The unfunded actuarial accrued liability (UAAL) is calculated as:
   (a) the present value of all plan 1 benefits
   (b) less the plan 1 actuarial assets
   (c) less the present value of plan 1 future normal cost rate contributions which are equal to plan 1 salaries times the sum of (i) the employer paid half of the normal cost rate described for plan 2 in item 1 above and (ii) the Plan 1 employee contribution rate.

3. The UAAL rate is calculated as the level percent of all future plan 1, 2 & 3 salaries through June 30, 2024 required to finance the UAAL for Plan 1. Note that the SERS salaries are included with the PERS salaries to pay off the PERS 1 UAAL The UAAL is

negative for LEOFF 1 as of September 30, 2003; therefore, no UAAL contributions are required for this plan.

Employer Contribution Rates: Employers (local and state) contribute half of the normal cost rate (i.e., the annual cost of member benefits as a percentage of salary) and all of the UAAL rate, if positive. Please see exceptions noted below.

Member Contribution Rates: With the exceptions noted below, members contribute as follows:

- ✓ Plan 1 members contribute 6% of pay,
- ✓ Plan 2 members contribute half the normal cost rate (minimum and maximum rates apply in some cases), and
- ✓ Plan 3 member contributions go into their defined contribution accounts.

Law Enforcement Officers and Fire Fighters Plan 1: The actuarial assets of LEOFF Plan 1 exceed the present value of all future benefits as of September 30, 2003. Since there is no UAAL, the LEOFF Plan 1 members and employers currently contribute 0% of pay.

Gain Sharing: Consistent with the RCW, the PERS, TRS & SERS Plan 2 member rate have been calculated so that they are not increased by the gain sharing amounts distributed to Plan 3 members. See Section 8 for more details.

Adjustments for Legislation: Note that some changes in liabilities due to recent legislation are not reflected in the liabilities used in this calculation. However, the contribution impact, as determined in the accompanying fiscal note to the legislation, is added to the calculated contribution rate. The changes due to the legislation will be reflected in the calculated liabilities in the subsequent valuation.

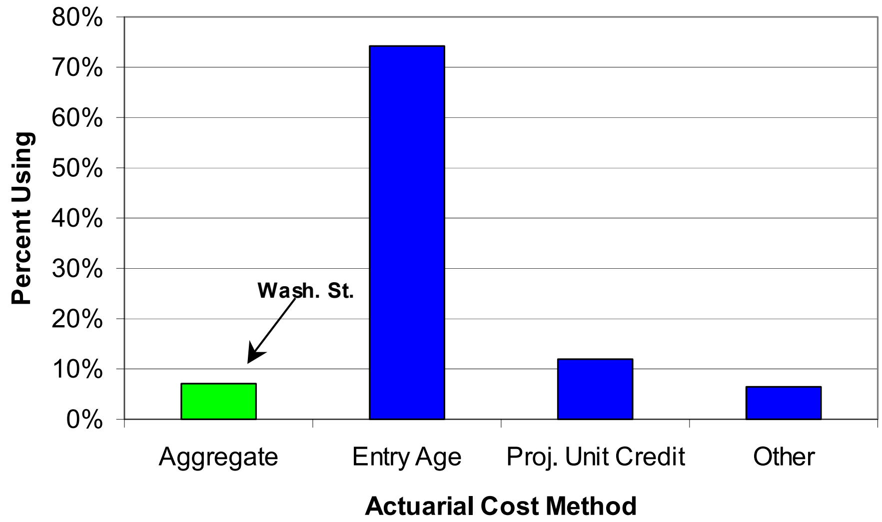
Cost Method

Purpose of a Cost Method: The purpose of any cost method is to allocate the cost of future benefits to specific time periods. Most public plans follow one of a group of generally accepted funding methods, which allocate the cost over the members' working years. In this way benefits are financed during the time in which services are provided.

Most Common Public Plan Cost Method (Entry Age): The most common cost method used by public plans is the Entry Age Actuarial Cost Method. The focus of the Entry Age cost method is the level allocation of costs over the member's working lifetime. For a public plan this means current taxpayers pay their fair share of the pensions of the public employees who are currently providing services. Current taxpayers are not expected to pay for services received by a past generation, nor are they expected to pay for the services that will be received by a future generation. The cost method does not anticipate increases or decreases in allocated costs. Although less common, the aggregate cost method is a reasonable method to fund a retirement system.

Draft

The 2003 Public Funds Survey shows that about 7% of statewide systems are using the aggregate funding method, as illustrated in the graph below. The Entry Age cost method is by far the most common.



Appropriate Funding Level

The Government Accounting Standards Board (GASB) provides general guidelines on the appropriate funding of a public retirement system. In general, it expects each system to receive contributions equal to the normal cost plus an amortization payment of either the UAAL or surplus amount.

The payment on a positive UAAL amount should be at least equal to a 30-year amortization payment. Under the aggregate funding method, liabilities are amortized over the average expected work life of all members. Generally, this results in an amortization period of about 15 years, well below the GASB minimum requirement.

In aggregate, the Washington State retirement systems have a funding ratio of 110% as of September 30, 2003 based on service to date. That is, the actuarial value of assets exceeds the present value of its credited projected benefits (benefits based on current service and projected salary) by about 10%. The funding ratio does not take into account the deferred asset losses. Relative to most other public plans, the systems in aggregate are well-funded. As a comparison, the 2003 Public Funds Survey shows that statewide systems on average have a funding ratio of about 90%.

Draft

Section 7
Actuarial Assumptions

Audit Conclusion

The review of actuarial assumptions is beyond the scope of this audit. The current set of assumptions was reviewed two years ago. At that time, we concluded that the assumptions were "reasonable and appropriate" to use in the actuarial valuation.

Comments

It should be noted that certain assumptions used for funding purposes and calculating the contribution rates do not comply with the GASB parameters for determining the disclosure information. The OSA makes the appropriate changes in assumptions to determine the appropriate accounting information.

Draft

Section 8
Gain-Sharing

Audit Conclusion

The OSA uses a reduction in the expected investment return to account for the estimated value of future gain-sharing payments. We agree that this is an appropriate method to value gain-sharing. We also found that the reduction amount (0.40%) used by the OSA is reasonable.

Comments

Gain Sharing Provisions

The gain-sharing provisions increase member benefits in periods of "extraordinary investments gains". These are periods in which the compound four-year average investment return exceeds 10%. The amount used for gain sharing is one-half of the sum of the returns in excess of 10% multiplied by the portion of members eligible for gain-sharing (based on service credit). The gain-sharing is applied in even-numbered years as follows:

- ✓ **PERS 1 & TRS 1 (RCW 41.31)**: The gain-sharing amount is used to increase the annual increase component of the Uniform COLA. Currently, about 1/3rd of the annual increase is attributable to gain-sharing.
- ✓ **PERS, TRS & SERS Plan 3 (RCW 41.31A)**: A fixed-dollar amount based on years of credited service is distributed into members' defined contributions accounts.
- ✓ **PERS, TRS & SERS Plan 2, LEOFF 1 & 2, and WSP 1 & 2**: No gain-sharing.

OSA Approach

As explained in greater detail below, gain-sharing results in lower expected investment returns for the funds set aside to pay benefits, since some of the investment earnings will be distributed to members through the gain-sharing provisions. For this reason, the OSA determined an interest rate adjustment to reflect the lower expected returns. This adjustment was based upon calculations for the expected asset returns provided by the Washington State Investment Board.

The OSA determined the value of the gain-sharing provisions as the difference between the value of "regular" benefits (the benefits expected to be paid to members outside of gain-sharing benefits) discounted at the two interest rates: 1) the expected return without the gain-sharing provisions; and, 2) the expected return after the adjustment for gain-sharing. The OSA reflected the fact that the gain-sharing benefits are only payable in even-numbered years and are not payable to members in every plan. The OSA's calculations do not affect member rates, because as specified in RCW 41.45.061 (6), the gain-sharing provisions do not affect member contribution rates. Only the employer rates increase, since employers are responsible for the entire cost of these provisions.

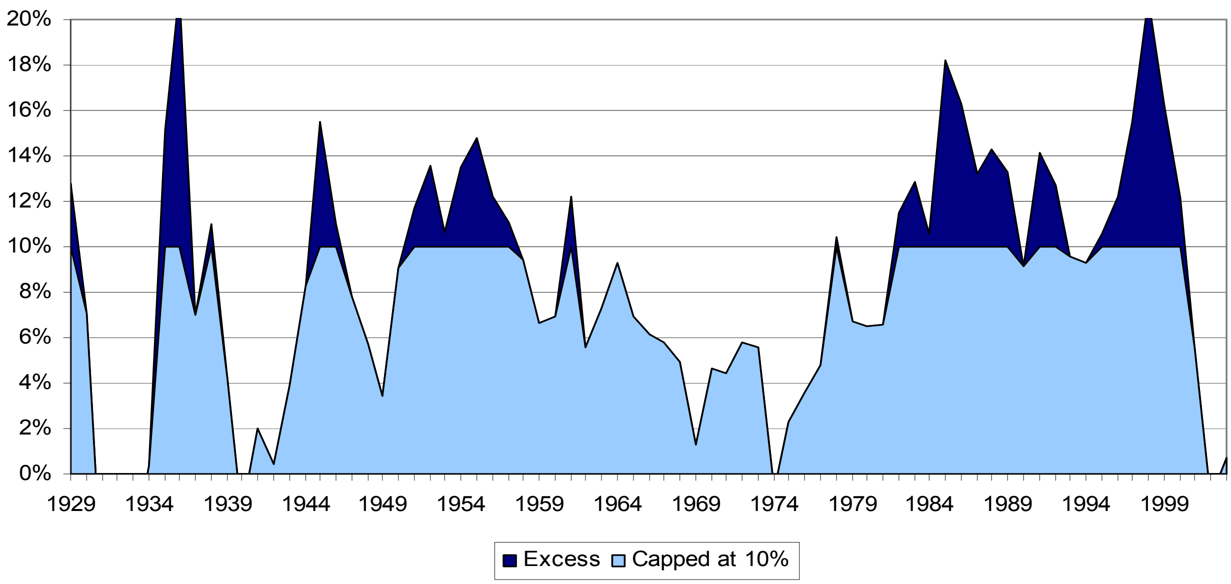
Draft

Is this Approach Reasonable?

Since the investment return assumption of 8% is less than the threshold of 10%, a standard actuarial valuation would not project gain-sharing to occur, because the standard actuarial valuation takes a deterministic approach with a single fixed rate assumption. However, the 8% is a long-term assumption that reflects that some years the return will be less than the assumptions and some years it will be greater. In those years where the four-year average of investment returns exceeds 10%, benefits to members will be increased. Thus, gain-sharing increases the present value of benefits that members are expected to receive. Because the gain-sharing program systematically provides for the possibility of additional benefits to members, it must have an impact on plan assets over time. From an actuarial perspective, there are several ways to reflect this. We feel that lowering the interest rate assumption to value liabilities is an appropriate method to value gain-sharing.

If the fund is expected to earn 8.0% over the long term, the use of excess returns (over the 10% threshold) for purposes other than funding the regular pension benefits will impact the long-term assumption, as shown in the following graph. Based on historical data, we have shown the investment return for a fund which averaged 8.0% over that time. If this were the case for the Washington systems, the dark area (returns in excess of 10%) would be diverted to fund the gain-sharing benefits. As a result, only the light area would be available to fund the regular pension benefits. Since the excess returns would no longer be available to offset the impact of the poor returns, the overall return will be lower. Note that since gain-sharing only occurs every other year and only one-half is used, only one-fourth of the excess returns would be used for the plans that have gain sharing and it would be in proportion to the service credit for eligible employees for those plans.

Historical Investment Returns
4-Year Average on Market



Based on our analysis we found the 0.40% additional investment return reasonably approximates the value of expected future gain-sharing benefits. We also agree that lowering the interest rate assumption to value liabilities is an appropriate method to value gain-sharing. Note that the full 8% investment return assumption is still used for items such as valuing the present value of future salaries and determining the expected return on assets.

Draft

Section 9
Summary of Recommendations & Considerations

Recommendations and Considerations

We are not recommending any changes to the valuation.

Considerations

There is one area where a change might be considered sometime in the future.

- ✓ **Assets:** As discussed in Section 4 of this report, one aspect of the work the OSA does to prepare the actuarial valuation is compiling all the asset information from several sources. This is because the regular audited financial statements are created as of June 30, the State's fiscal year end. However, the valuation results are as of September 30.

  Also, the rate of return on the assets is based solely on the assets held by the SIB. While this represents the vast majority of the assets for the plan, small differences in the return rate can result in a slightly different smoothing period in determining the actuarial value of assets, which can impact the contribution rates. If the valuation date was the same as the fiscal year end, both of these issues would be addressed. We realize there are reasons for the current procedures; however, it would be preferable to have audited financial statements consistent with the valuation date.

Draft

Appendix A
Detailed Data Summary

PERS

	OSA Summary			Milliman Summary			Ratio OSA / Milliman		
	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
Active Members									
Number	19,740	117,262	17,548	19,738	117,262	17,548	100.0%	100.0%	100.0%
Total Salary (Millions)	$945	$5,143	$787	$945	$5,137	$784	100.0%	100.1%	100.3%
Average Age	55.2	44.6	42.2	55.2	44.6	42.1	100.0%	99.9%	100.1%
Average Service	21.5	9.0	8.5	21.4	9.0	8.5	100.4%	100.4%	100.3%
Average Salary	$47,876	$43,855	$44,823	$47,889	$43,804	$44,679	100.0%	100.1%	100.3%
Terminated Members									
Number Vested	3,142	16,089	770	3,141	16,081	770	100.0%	100.0%	100.0%
Number Non-Vested	6,525	78,853	0	6,525	78,853	0	100.0%	100.0%	100.0%
Retirees									
Number	54,372	10,904	86	54,386	10,908	86	100.0%	100.0%	100.0%
Avg. Monthly Benefit	$1,249	$618	$406	$1,249	$617	$406	100.0%	100.1%	100.0%

TRS

	OSA Summary			Milliman Summary			Ratio OSA / Milliman		
	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
Active Members									
Number	11,175	7,637	47,263	11,172	7,637	47,262	100.0%	100.0%	100.0%
Total Salary (Millions)	$692	$415	$2,308	$691	$415	$2,302	100.2%	100.1%	100.2%
Average Age	55.4	49.3	41.1	55.4	49.3	41.1	100.1%	99.9%	99.9%
Average Service	24.0	12.1	8.3	23.9	12.1	8.4	100.4%	100.1%	99.2%
Average Salary	$61,954	$54,333	$48,836	$61,865	$54,292	$48,718	100.1%	100.1%	100.2%
Terminated Members									
Number Vested	1,647	2,493	2,418	1,648	2,493	2,420	99.9%	100.0%	99.9%
Number Non-Vested	776	4,169	0	776	4,169	0	100.0%	100.0%	100.0%
Retirees									
Number	33,855	957	385	33,880	958	386	99.9%	99.9%	99.7%
Avg. Monthly Benefit	$1,539	$941	$407	$1,538	$941	$406	100.0%	100.0%	100.2%

Draft

SERS

	OSA Summary			Milliman Summary			Ratio OSA / Milliman		
	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
Active Members									
Number		21,504	27,710		21,505	27,710		100.0%	100.0%
Total Salary (Millions)		$494	$639		$494	$636		100.0%	100.5%
Average Age		48.3	45.8		48.3	45.8		100.0%	100.1%
Average Service		8.6	7.2		8.6	7.1		99.7%	100.8%
Average Salary		$22,967	$23,051		$22,965	$22,942		100.0%	100.5%
Terminated Members									
Number Vested		1,902	1,648		1,903	1,648		99.9%	100.0%
Number Non-Vested		4,232	0		4,232	0		100.0%	100.0%
Retirees									
Number		736	306		736	306		100.0%	100.0%
Avg. Monthly Benefit		$518	$231		$518	$231		100.0%	100.0%

LEOFF 1

	OSA Summary			Milliman Summary			Ratio OSA / Milliman		
	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3	Plan 1	Plan 2	Plan 3
Active Members									
Number	991			991			100.0%		
Total Salary (Millions)	$71			$71			99.8%		
Average Age	54.0			54.0			100.0%		
Average Service	29.3			29.3			100.1%		
Average Salary	$71,924			$72,062			99.8%		
Terminated Members									
Number Vested	14			14			100.0%		
Number Non-Vested	84			84			100.0%		
Retirees									
Number	8,054			8,054			100.0%		
Avg. Monthly Benefit	$2,796			$2,796			100.0%		

WSP	OSA Summary			Milliman Summary			Ratio OSA / Milliman		
	Plan 1	**Plan 2**	**Plan 3**	**Plan 1**	**Plan 2**	**Plan 3**	**Plan 1**	**Plan 2**	**Plan 3**
Active Members									
Number	1,045	34		1,045	34		100.0%	100.0%	
Total Salary (Millions)	$65	$1		$65	$1		99.9%	100.0%	
Average Age	38.8	28.8		38.8	28.8		100.1%	100.1%	
Average Service	12.2	0.8		12.2	0.8		100.3%	100.1%	
Average Salary	$61,848	$41,019		$61,905	$41,020		99.9%	100.0%	
Terminated Members									
Number Vested	32	0		32	0		100.0%	100.0%	
Number Non-Vested	20	0		20	0		100.0%	100.0%	
Disabled Members	61			61			100.0%		
Retirees									
Number	735	0		735			100.0%		
Average Monthly Benefit	$2,884			$2,884			100.0%		

Draft

Appendix B
Detailed Comparison of Liabilities
(Dollar Amounts in Millions)

	PERS Plan 1			PERS Plans 2 & 3		
	OSA	Milliman	Ratio	OSA	Milliman	Ratio
Active Members						
Retirement	$ 4,343.2	$ 4,388.1	99.0%	$ 11,607.3	$ 11,517.4	100.8%
Termination	45.7	46.0	99.3%	713.7	718.9	99.3%
Death	64.2	62.1	103.4%	240.9	241.9	99.6%
Disability	35.5	35.3	100.6%	97.6	103.6	94.2%
Portability	9.2	9.4	97.9%	38.1	38.0	100.3%
Uniform COLA	393.9	401.5	98.1%	-	-	100.0%
Total Active	**$ 4,892**	**$ 4,942**	99.0%	**$ 12,698**	**$ 12,620**	100.6%
Annual Salary	$ 945	$ 945	100.0%	$ 5,929	$ 5,929	100.0%
PV Fut. Salaries	$ 4,224	$ 4,062	104.0%	$ 58,979	$ 59,149	99.7%
Inactive Members						
Terminated	$ 253.6	$ 259.5	97.7%	$ 717.3	$ 708.3	101.3%
Service Retired	6,650.2	6,649.9	100.0%	781.5	778.1	100.4%
Disability Retired	111.2	109.8	101.3%	47.5	47.5	100.0%
Survivors	378.3	381.1	99.3%	34.1	34.3	99.4%
Uniform COLA	934.2	975.0	95.8%	-	-	100.0%
Total Inactive	**$ 8,328**	**$ 8,375**	99.4%	**$ 1,580**	**$ 1,568**	100.8%
All PERS Members	**$ 13,219**	**$ 13,318**	99.3%	**$ 14,278**	**$ 14,188**	100.6%

Draft

	TRS Plan 1			TRS Plans 2 & 3		
	OSA	Milliman	Ratio	OSA	Milliman	Ratio
Active Members						
Retirement	$ 3,461.1	$ 3,470.4	99.7%	$ 4,642.2	$ 4,714.0	98.5%
Termination	18.2	18.3	99.5%	136.0	128.5	105.8%
Death	35.9	35.5	101.1%	67.5	68.0	99.3%
Disability	10.0	10.0	100.0%	5.1	5.1	100.0%
Portability	11.0	11.1	99.1%	5.0	5.0	100.0%
Uniform COLA	301.5	288.8	104.4%	-	-	100.0%
Total Active	**$ 3,838**	**$ 3,834**	100.1%	**$ 4,856**	**$ 4,921**	98.7%
Annual Salary	$ 692	$ 692	100.0%	$ 2,723	$ 2,723	100.0%
PV Fut. Salaries	$ 2,996	$ 3,122	96.0%	$ 33,689	$ 33,438	100.7%
Inactive Members						
Terminated	$ 209.8	$ 203.4	103.1%	$ 208.2	$ 204.4	101.9%
Service Retired	5,581.2	5,561.1	100.4%	147.1	146.1	100.7%
Disability Retired	95.4	96.6	98.8%	4.6	4.6	100.0%
Survivors	211.2	212.5	99.4%	4.4	4.5	97.8%
Uniform COLA	831.7	861.5	96.5%	-	-	100.0%
Total Inactive	**$ 6,929**	**$ 6,935**	99.9%	**$ 364**	**$ 360**	101.3%
All TRS Members	**$ 10,767**	**$ 10,769**	100.0%	**$ 5,220**	**$ 5,280**	98.9%

	SERS Plans 2 & 3		
	OSA	Milliman	Ratio
Active Members			
Retirement	$ 1,787.6	$ 1,788.4	100.0%
Termination	153.2	147.4	103.9%
Death	29.6	29.9	99.0%
Disability	11.4	12.1	94.2%
Portability	6.0	6.1	98.4%
Uniform COLA	-	-	100.0%
Total Active	**$ 1,988**	**$ 1,984**	100.2%
Annual Salary	$ 1,133	$ 1,133	100.0%
PV Fut. Salaries	$ 10,274	$ 10,153	101.2%
Inactive Members			
Terminated	$ 81.8	$ 80.8	101.2%
Service Retired	63.4	62.6	101.3%
Disability Retired	3.2	3.3	97.0%
Survivors	1.3	1.3	100.0%
Uniform COLA	-	-	100.0%
Total Inactive	**$ 150**	**$ 148**	101.1%
All SERS Members	**$ 2,137**	**$ 2,132**	100.3%

Draft

	LEOFF Plan 1				
	OSA		Milliman		Ratio
Active Members					
Retirement	$	408.7	$	408.4	100.1%
Termination		0.7		0.7	100.0%
Death		6.9		7.0	98.6%
Disability		206.7		204.2	101.2%
Portability		-		-	100.0%
Uniform COLA		-		-	100.0%
Total Active	**$**	**623**	**$**	**620**	100.4%
Annual Salary	$	71	$	71	100.0%
PV Fut. Salaries	$	234	$	234	100.1%
Inactive Members					
Terminated	$	8.3	$	8.4	98.8%
Service Retired		1,305.8		1,301.1	100.4%
Disability Retired		2,028.8		2,018.9	100.5%
Survivors		375.6		377.7	99.4%
Uniform COLA		-		-	100.0%
Total Inactive	**$**	**3,718**	**$**	**3,706**	100.3%
LEOFF 1 Members	**$**	**4,341**	**$**	**4,326**	100.3%

	WSP Plan 1					WSP Plan 2				
	OSA		Milliman		Ratio	OSA		Milliman		Ratio
Active Members										
Retirement	$	375.5	$	376.8	99.7%	$	5.0	$	4.8	103.8%
Termination		4.1		4.1	100.0%		0.2		0.2	100.0%
Death		6.5		6.4	101.6%		0.1		0.1	100.0%
Disability		0.3		0.3	100.0%		-		-	100.0%
Portability		-		-	100.0%		-		-	100.0%
Uniform COLA		-		-	100.0%		-		-	100.0%
Total Active	**$**	**386**	**$**	**388**	99.7%	**$**	**5.3**	**$**	**5.1**	103.5%
Annual Salary	$	65	$	65	100.0%	$	1	$	1	100.0%
PV Fut. Salaries	$	757	$	755	100.2%	$	31	$	31	100.0%
Inactive Members										
Terminated	$	2.8	$	2.8	100.0%	$	-	$	-	100.0%
Service Retired		314.4		316.3	99.4%		-		-	100.0%
Disability Retired		1.4		1.7	82.4%		-		-	100.0%
Survivors		16.8		16.9	99.4%		-		-	100.0%
Uniform COLA		-		-	100.0%		-		-	100.0%
Total Inactive	**$**	**335**	**$**	**338**	99.3%	**$**	**-**	**$**	**-**	100.0%
All WSP Members	**$**	**722**	**$**	**725**	99.5%	**$**	**5.3**	**$**	**5.1**	103.5%

WASHINGTON STATE LEGISLATURE

Office of the State Actuary

August 30, 2004

Senator Joseph Zarelli, Chair, Ways and Means Committee
Senator Margarita Prentice, Ranking Minority Member, Ways and Means Committee
Representative Helen Sommers, Chair, Appropriations Committee
Representative Barry Sehlin, Ranking Minority Member, Appropriations Committee
Mr. John Charles, Director, Department of Retirement Systems
Mr. Marty Brown, Director, Office of Financial Management

RE: PRELIMINARY 2005-07 PENSION CONTRIBUTION RATES

As required under RCW 41.45.060, I am providing the preliminary results of the 2003 actuarial valuation of the following Washington State retirement systems:

- Public Employees Retirement System (PERS);
- Teachers Retirement System (TRS);
- School Employees Retirement System (SERS);
- Law Enforcement Officers and Fire Fighters Retirement System, Plan 1 (LEOFF 1); and
- Washington State Patrol Retirement System (WSP).

The primary purpose of the valuation was to determine contribution requirements for the systems listed above as of the valuation date September 30, 2003 and should not be used for other purposes. The results are based on the economic assumptions and asset value smoothing technique included in RCW 41.45.035.

Gain-Sharing Benefits

As noted in the actuarial certification of the 2002 Actuarial Valuation Report, the gain-sharing benefit provisions of PERS and TRS Plans 1, PERS, TRS and SERS Plans 3 were not previously reflected in the actuarial valuations. The funding methodology and materiality of these benefit provisions were reviewed and the benefit provisions were determined to represent a material actuarial liability to the affected retirement systems. This material liability is recognized in the 2003 actuarial valuation and reflected in the attached preliminary contribution rate tables.

2100 Evergreen Park Drive S.W., Suite 150
P.O. Box 40914
Olympia, WA 98504-0914
(360) 753-9144

FAX: (360) 586-8135
TDD: 1-800-635-9993
E-MAIL: actuary_st@leg.wa.gov

Preliminary Results

I will forward a final actuarial valuation report to the council this fall. An executive summary of the 2003 valuation results is provided below.

Summary Comments

As of September 30, 2003, the Washington State retirement systems remain in a solid funding position. The funded ratio (actuarial assets divided by credited projected liability) for all systems combined is 110%. In other words, the combined plans have $1.10 in actuarial or smoothed assets for every $1 of accrued liability. This combined funded measure is provided for summarization purposes only since assets from one qualified retirement plan cannot be used to fund benefits for another plan. On an individual plan basis, all of the state's plan 2/3 systems and the WSP retirement system have funded ratios well in excess of 100%. Funded ratios for PERS 1, TRS 1 and LEOFF 1 are 85%, 93% and 112% respectively.

Unfunded actuarial accrued liability (UAAL) is re-emerging for PERS 1 and TRS 1 and their funded ratios are expected to drop in the short term due to the annual recognition of past investment losses that are not yet fully recognized in the actuarial value of assets. RCW 41.45.054 suspended payments toward the PERS and TRS Plan 1 UAAL. Future increases in the PERS and TRS Plan 1 UAAL contribution rates will be required to fully amortize the unfunded prior service costs in these plans at June 30, 2024 - as provided under current law.

Contribution Rates

As noted above, an increase in current employer and plan 2 member contribution rates is required to continue to fund retirement system benefits under the state's funding policy as provided in Chapter 41.45 RCW - Actuarial Funding of State Retirement Systems. The higher employer contribution rates represent a $616 million GF-S increase above the current biennial level. Preliminary employer and plan 2 member contribution rates for the 2005-07 biennium are provided under Attachment A. The required increase above current contribution rate levels is provided for your reference. Attachment B displays preliminary employer contributions for the 2005-07 biennium and increases above the current biennium.

The recognition of actuarial liability associated with future gain-sharing benefits in PERS and TRS Plans 1 and PERS, TRS and SERS Plans 3 had a significant impact on the 2003 preliminary valuation results. The higher employer contribution rates associated with future gain-sharing account for $176 million of the estimated $616 million GF-S increase. The remaining $440 million increase is primarily due to the recognition of past investment losses that are not yet fully recognized in the actuarial value of assets. Attachment C illustrates the impact of future gain-sharing benefits on required employer contributions for the next biennium.

I hope you find this information useful during your deliberations. Please don't hesitate to contact me directly should you require any additional information.

Sincerely,

Matthew M. Smith
State Actuary

cc: Pension Funding Council Work Group

Attachments

O:\PFC\2004\Preliminary 05-07 rates.wpd

ATTACHMENT A

Preliminary 2005-07 Contribution Rates

Preliminary Employer Contribution Rates

System	2005-07 Biennium	Current Rates*	Difference
PERS	5.73%	1.19%	4.54%
TRS	6.74%**	1.18%	5.56%
SERS	7.56%	0.85%	6.71%
LEOFF 1	0.00%	0.00%	0.00%
WSP	4.51%	0.00%	4.51%

** Includes supplemental rate increases effective 9/1/2004.*
*** Includes an additional 0.01% for the non-automatic post-retirement benefit increase provided under Chapter 85, Laws of 2004.*

Preliminary Plan 2 Member Contribution Rates*

System	2005-07 Biennium	Current Rates	Difference
PERS	3.38%	1.18%	2.20%
TRS	2.48%	0.87%	1.61%
SERS	3.51%	0.85%	2.66%
WSP**	4.51%	2.00%	2.51%

** The member contribution rate in PERS 1 and TRS 1 is fixed at 6%. No member contribution is currently required for LEOFF 1 under current funding policy. Plan 3 members do not contribute to the defined benefit portion of their plan.*
***All members*

ATTACHMENT B

Preliminary Employer Contributions

Preliminary 2005-07 Employer Contributions
(Estimated Dollars in Millions)

System	GF-S	Non GF-S (State)	Local Government	Total Employer
PERS	$ 189.9	$ 313.4	$ 446.2	$ 949.5
TRS	411.6	0.0	84.4	496.0
SERS	105.7	0.0	93.6	199.3
LEOFF*	69.1	0.0	103.8	172.9
WSP	0.4	6.8	0.0	7.2
Total	**$ 776.7**	**$ 320.2**	**$ 728.0**	**$ 1,824.9**
Current Biennium**	**$ 161**	**$ 60**	**$ 174**	**$ 395**
Difference	**$ 615.7**	**$ 260.2**	**$ 554.0**	**$ 1,429.9**

** Includes preliminary results for LEOFF 2. Contribution rates for LEOFF 2 are adopted by the LEOFF 2 Retirement Board.*

*** Estimate*

Note: 2005-07 rate increases for TRS and SERS are effective 9/1/2005 through 8/31/2007. The impact of these rate increases on the 2007-09 biennium is not reflected in the above table.

ATTACHMENT C

Preliminary Contributions Without Gain Sharing

Preliminary 2005-07 Employer Contributions - Without Gain Sharing
(Estimated Dollars in Millions)

System	GF-S	Non GF-S (State)	Local Government	Total Employer
PERS	$ 168.5	$ 277.8	$ 395.7	$ 842.0
TRS	289.0	0.0	59.2	348.2
SERS	74.1	0.0	65.6	139.7
LEOFF*	69.1	0.0	103.8	172.9
WSP	0.4	6.8	0.0	7.2
Total	**$ 601.1**	**$ 284.6**	**$ 624.3**	**$ 1,510.0**
05-07 with Gain Sharing	**$ 776.7**	**$ 320.2**	**$ 728.0**	**$ 1,824.9**
Difference	**$ (175.6)**	**$ (35.6)**	**$ (103.7)**	**$ (314.9)**

** Includes preliminary results for LEOFF 2. Contribution rates for LEOFF 2 are adopted by the LEOFF 2 Retirement Board.*

Note: 2005-07 rate increases for TRS and SERS are effective 9/1/2005 through 8/31/2007. The impact of these rate increases on the 2007-09 biennium is not reflected in the above table.

Deferred Rate Increases

(September 3, 2004)

Issue

The Pension Funding Council (PFC) subgroup of the SCPP proposed a 6-year phase-in of projected employer and plan 2 member contribution rates. Additionally, a permanent contribution rate floor would be established at the completion of the 6-year phase-in period.

Staff

Matt Smith, State Actuary
360-753-9144

Members Impacted

All employers and plan 2 members of the Public Employees Retirement System (PERS), Teachers Retirement System (TRS) and the School Employees' Retirement System (SERS) would be impacted. As of September 30, 2003, there were 146,403 plan 2 members in PERS, TRS and SERS. Of this combined total, 117,262 are PERS Plan 2 members.

Current Situation

Provisions governing the current contribution rate setting process are codified under the Actuarial Funding Chapter - Chapter 41.45 RCW. In summary, these provisions provide for the systematic actuarial funding of the state retirement systems. Biennial actuarial valuations performed on odd-year valuation dates are the basis for contribution rate recommendations to the Pension Funding Council (PFC). Contribution rates adopted by the PFC in September of even-numbered years, referred to as "basic rates," are effective during the ensuing biennium subject to revision by the Legislature. Temporary and "supplemental rates" are charged in addition to the basic rates to fund the cost of benefit enhancements that are granted by the Legislature in between the 2-year basic rate cycles.

History

The Pension Funding Reform Act, Chapter 273, Laws of 1989, established a systematic actuarial funding process for the state retirement systems. Contribution rates under the initial Funding Reform Act were scheduled to remain in place for a 6-year period. Additionally, the current funding policy was established including the goal to fully amortize the plan 1 unfunded liability by June 30, 2024. Prior to the Funding Reform Act, pension contributions were subject to a discretionary appropriation by the Legislature.

Projected Contribution Rates

Projected Employer Contribution Rates*

System	Current	2005-07	2007-09	2009-11
PERS	1.18%	5.73%	7.28%	8.44%
TRS	1.17%	6.74%	10.15%	12.73%
SERS	0.85%	7.56%	9.45%	10.69%

** Includes the cost of prefunding the liability for existing gain-sharing benefit provisions.*

Projected Plan 2 Member Contribution Rates*

System	Current	2005-07	2007-09	2009-11
PERS	1.18%	3.38%	4.27%	4.89%
TRS	0.87%	2.48%	4.01%	5.01%
SERS	0.85%	3.51%	4.68%	5.39%

** The member contribution rate in PERS and TRS Plan 1 is fixed at 6%. Plan 3 members do not contribute to the defined benefit portion of their plan.*

PFC Subgroup Recommendation

The PFC subgroup of the SCPP proposed a 6-year phase-in of projected employer and plan 2 member contribution rates. Additionally, a permanent contribution rate floor would be established at the completion of the 6-year phase-in period.

Proposed Employer Rates Under 6-Year Phase-In

Employer Rates With Phase-In

Period	PERS	TRS	SERS
2005-06	4.25%	5.00%	6.00%
2006-07	5.25%	6.75%	7.00%
2007-08	6.25%	8.75%	8.50%
2008-09	7.25%	10.75%	10.00%
2009-11	8.44%	12.73%	10.69%
Ultimate Rate*	9.47%	14.59%	11.71%

** The ultimate rate is the maximum projected employer contribution rate for the 25-year period.*

Employer Rates Without Phase-In

Period	PERS	TRS	SERS
2005-06	5.73%	6.74%	7.56%
2006-07	5.73%	6.74%	7.56%
2007-08	7.28%	10.15%	9.45%
2008-09	7.28%	10.15%	9.45%
2009-11	8.44%	12.73%	10.69%
Ultimate Rate*	9.11%	14.28%	11.37%

** The ultimate rate is the maximum projected employer contribution rate for the 25-year period.*

Proposed Plan 2 Member Rates Under 6-Year Phase-In

Plan 2 Member Rates With Phase-In

Period	PERS	TRS	SERS
2005-06	2.75%	2.00%	2.75%
2006-07	3.25%	2.75%	3.25%
2007-08	3.75%	3.50%	4.25%
2008-09	4.25%	4.25%	5.25%
2009-11	4.89%	5.01%	5.39%
Ultimate Rate*	5.35%	5.61%	5.83%

** The ultimate rate is the maximum projected member contribution rate for the 25-year period.*

Plan 2 Member Rates Without Phase-In

Period	PERS	TRS	SERS
2005-06	3.38%	2.48%	3.51%
2006-07	3.38%	2.48%	3.51%
2007-08	4.27%	4.01%	4.68%
2008-09	4.27%	4.01%	4.68%
2009-11	4.89%	5.01%	5.39%
Ultimate Rate*	5.18%	5.53%	5.68%

** The ultimate rate is the maximum projected member contribution rate for the 25-year period.*

Policy Analysis

The proposed phase-in of projected contribution rate increases would represent a temporary departure from existing funding policy and would require a statutory change to the existing funding policy defined under Chapter 41.45 RCW - Actuarial Funding of State Retirement Systems. Employer and plan 2 member contribution rates would drop below the amounts necessary to fully fund the plans 2/3 under the aggregate funding method during the phase-in period and then increase thereafter. Contributions to the amortize the unfunded prior service costs in PERS 1 and TRS 1 during the phase-in period would also drop below the amounts that would otherwise be required and increase thereafter. The amortization date for the Plans 1, however, would remain unchanged.

This proposal is consistent with the existing policy that states that employer contribution rates should be predictable and remain a relatively constant proportion of future state budgets. This proposal would establish a fixed schedule of increasing contribution rates for a 6-year period, thereby increasing predictability, and would smooth out the impact of projected rate increases on future state and local government budgets. The addition of a permanent contribution rate floor at the completion of the phase-in period is also consistent with this policy – increasing the stability and predictability of future contribution rates.

This proposal is inconsistent with the existing policy to fund all Plan 2/3 benefits over the working lives of those members so that the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service, and would be a first-time departure from this policy. The proposal would effectively borrow plan assets in the short-term as a means of financing a schedule of deferred rate increases during the phase-in period - without permanently modifying existing funding policy. This would result in short-term savings, followed by a long-term cost.

Estimated Fiscal Impact

Increase in Projected Funding Expenditures

($ in millions)	**GF-S**	**Non GF-S (State)**	**Local Government**	**Total Employer**
2005-07				
PERS	$ (35.8)	$ (59.0)	$ (84.0)	$ (178.8)
TRS	(66.4)	0.0	(13.6)	(80.0)
SERS	(18.4)	0.0	(16.3)	(34.7)
Total Employer	**$ (120.6)**	**$ (59.0)**	**$ (113.9)**	**$ (293.5)**
2007-09				
PERS	$ (19.6)	$ (32.4)	$ (46.1)	$ (98.1)
TRS	(36.5)	0.0	(7.5)	(44.0)
SERS	(3.2)	0.0	(2.9)	(6.1)
Total Employer	**$ (59.3)**	**$ (32.4)**	**$ (56.5)**	**$ (148.2)**

($ in millions)	GF-S	Non GF-S (State)	Local Government	Total Employer
2009-11*				
PERS	$ 0.0	$ 0.0	$ 0.0	$ 0.0
TRS	(4.0)	0.0	(0.8)	(4.8)
SERS	(0.5)	0.0	(0.4)	(0.9)
Total Employer	**$ (4.5)**	**$ 0.0**	**$ (1.2)**	**$ (5.7)**
25 Year				
PERS	$ 73.1	$ 120.7	$ 171.9	$ 365.7
TRS	143.0	0.0	29.3	172.3
SERS	35.2	0.0	31.2	66.4
Total Employer	**$ 251.3**	**$ 120.7**	**$ 232.4**	**$ 604.3**

**2007-09 rate increases for TRS and SERS are effective 9/1/2007 through 8/31/2009.*

The proposed schedule of future rate increases should be adjusted for any significant divergence between actual and assumed experience - including the cost of any future benefit enhancements.

The estimated fiscal impact is based on the proposed schedule of rate increases presented in this paper. Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2002 actuarial valuation report and using preliminary contribution rates from the 2003 actuarial valuation. The cost of adding a permanent contribution rate floor is not reflected.

The proposed schedule of future rate increases was developed under an actuarial projection of assets and liabilities. The emerging costs of the affected systems will vary from what is displayed in this paper to the extent that actual experience differs from that projected under the current actuarial assumptions.

This proposal assumes a fixed schedule of increasing contribution rates and a permanent contribution rate floor at the completion of the phase-in period. However a current Legislature cannot obligate a future Legislature for contribution rate increases that would impact a future biennial budget. The proposed schedule of future contribution rate increases, if approved by the 2005 Legislature, could be amended by a future Legislature. If the minimum funding requirements set forth in the schedule were not honored by future Legislatures, the costs in the tables above could be understated.

WASHINGTON STATE LEGISLATURE

Office of the State Actuary

September 7, 2004

TO: Select Committee on Pension Policy (SCPP) Members

FROM: Matt Smith, State Actuary

SUBJECT: 2005-07 OSA BUDGET REQUEST

Enclosed please find a copy of the 2005-07 budget request for the Office of the State Actuary (OSA). SCPP Rule of Procedure 8(F) requires the State Actuary to submit the biennial budget request to the SCPP for approval. Agency budget requests must be submitted to the Office of Financial Management by October 1, 2004.

The enclosed budget request includes the following items:

- description of agency mission;
- statutory authority;
- OSA organizational chart; and
- 2005-07 budget documents.

The proposed 2005-07 budget represents an increase of $489,000 above the current 2003-05 biennial budget (18.5% increase). The $489,000 increase is comprised of a $55,000 increase for required carry forward items, $45,000 in changes for self-insurance premiums and merit pay increases, plus $389,000 to facilitate performance level changes.

The $389,000 increase to facilitate performance level changes includes funding for a business plan consultant, replacement of the actuarial valuation system, and the addition of a full-time publications specialist to the OSA staff.

Funding Source

Funding for the agency's budget is provided from the Department of Retirement Systems (DRS) Expense Fund. This fund is supported by an administrative expense rate that is collected by DRS from all retirement system employers. The current DRS administrative expense rate is 0.22%. Effective September 1, 2004, this administrative expense rate will drop to 0.19%. OSA's proposed 2005-07 budget request will not impact this expense rate.

2100 Evergreen Park Drive S.W., Suite 150
P.O. Box 40914
Olympia, WA 98504-0914
(360) 753-9144

FAX: (360) 586-8135
TDD: 1-800-635-9993

E-MAIL: actuary_st@leg.wa.gov

Business Plan Consultant

$8,000 is requested to hire an outside consultant to assist the SCPP in the development of a long-term business plan. The SCPP identified the development of a business plan as of one of the top four priorities at the May 2004 orientation.

Actuarial Valuation System

$200,000 is requested to fund the replacement of the actuarial valuation software. OSA currently runs and maintains an in-house actuarial valuation system that was developed during the late 1970s that includes unsupported software components. The requested funding would allow OSA to either purchase or lease a modern actuarial valuation system that would improve the efficiency of current actuarial services and allow OSA to provide a broader range of actuarial services.

Outside actuarial software packages can provide additional features such as integrated projection system, automated actuarial gain/loss analysis, stochastic asset-liability modeling and post-retirement medical valuations, which the current in-house software lacks. Additionally, modern software packages incorporate modern user-friendly interfaces and self-documenting internally consistent code for legislative costing and a quicker learning curve for new staff.

Leasing a modern actuarial valuation system would represent an on-going operating expense for the agency of approximately $200,000 per biennium. The purchase of a modern actuarial valuation system would represent a cost of approximately $500,000 to $800,000 that could be amortized over the next 2 to 4 biennial budgets.

Publications Specialist

$181,000 is requested to fund a permanent and full-time publications specialist position. Requested funding would offset the cost of salary and wages, employee benefits, goods and services, training and capital outlays for this position over a 2-year period.

Administrative support for all OSA functions, the SCPP, OSA and SCPP publications and web sites is currently provided with 2 full-time equivalent (FTE) positions. The replacement of the former Joint Committee on Pension Policy with the SCPP has resulted in increased demands on fixed administrative resources. Administrative resources in support of our publications and/or communications efforts have been transferred to the SCPP to address the increased demand.

The proposed additional FTE would allow OSA to address the increased administrative demands of the SCPP without sacrificing resources for publications and communication efforts. The proposed publications specialist position would serve as a dedicated resource for all OSA and SCPP publications and provide primary back-up for the agency's part-time webmaster.

OSA's publications and communication efforts are critical factors in the accomplishment of the agency's mission and vision. Current OSA and SCPP publications include the following: annual actuarial valuation report (AVR); LEOFF 2 AVR; actuarial valuation of the Volunteer Fire Fighters Pension and Relief System; SCPP Interim Issues Report; Annual Summary of Benefits (limited external distribution); Statutory Benefits History (internal); SCPP Orientation Manual; Experience Study Report; Statutory Basis for Retirement, Compensation, Fringe Benefits and Related Areas (limited external distribution); OSA Newsletter; SCPP Issue Papers; Personnel Manual (internal); and Special Studies. Potential new publications would include: citizen guides for pension funding and annual AVR "quick reference guide."

O:\SCPP\2004\9-7-04 Full\2005-07 budget memo.wpd

AGENCY MISSION

The Office of the State Actuary strives to ensure public faith and confidence in the Washington state retirement systems by providing reliable actuarial analysis and expert knowledge of pension issues for the Legislative and Executive Branches of the State of Washington.

The Office of the State Actuary is an agency within the Legislative Branch, functioning on two levels:

(1) The first functional level is that of actuary. This function requires specific professional and technical qualifications to apply the mathematical procedures utilized in the data analysis and recommendations necessary for valuations and periodic experience studies.

Valuations determine the fiscal status of a retirement system in order to know the funding required. They are prepared annually on each of the seven retirement systems funded by the state and administered by the Department of Retirement Systems.

Experience studies determine the validity of assumptions used for valuations and the adequacy of the funding system being utilized. These are prepared on five-year cycles. The Office provides an advisory and consulting role to the Legislature, Office of the Governor, Department of Retirement Systems and State Investment Board.

(2) The second functional level is that of staff support to the Select Committee on Pension Policy. This function mirrors the activity performed by other legislative committees. That is, it researches issues or subject areas at the direction of the Select Committee, provides verbal and written testimony on its research findings, and prepares and/or evaluates proposed legislation.

STATUTORY AUTHORITY

The powers and duties of the Office of State Actuary specified in RCW 44.44.040 are:

"(1) Perform all actuarial services for the department of retirement systems, including all studies required by law.
(2) Advise the legislature and the governor regarding pension benefit provisions, and funding policies and investment policies of the state investment board.
(3) Consult with the legislature and the governor concerning determination of actuarial assumptions used by the department of retirement systems.
(4) Prepare a report, to be known as the actuarial fiscal note, on each pension bill introduced in the legislature which briefly explains the financial impact of the bill. . . . An actuarial fiscal note shall also be prepared for all amendments which are offered in committee or on the floor of the house of representatives or the senate to any pension bill. . . .
(5) Provide such actuarial services to the legislature as may be requested from time to time.
(6) Provide staff and assistance to the committee established under RCW 41.04.276 [Select Committee on Pension Policy]." (Committee name added)
(7) Provide actuarial assistance to the law enforcement officers' and fire fighters' plan 2 retirement board as provided in chapter 2, Laws of 2003. . . ."

The Select Committee on Pension Policy was established by Chapter 295, Laws of 2003, and codified in RCW 41.04.276, .278, and .281. These statutes state:

RCW 41.04.276

"(1) There is hereby created a joint committee on pension policy. The committee shall consist of :
   (a) Eight members of the senate appointed by the president of the senate, four of whom shall be members of the majority party and four of whom shall be members of the minority party; and
   (b) Eight members of the house of representatives appointed by the speaker, four of whom shall be members of the majority party and four of whom shall be members of the minority party. . . .
(2) Each member's term of office shall run from the close of the session in which he or she was appointed until the close of the next regular session held in an

odd-numbered year. . . .

(3) The committee shall elect a chairperson and a vice-chairperson. . . .

(4) The committee shall establish an executive committee of four members including the chairperson and the vice-chairperson, representing the majority and minority caucuses of each house."

RCW 41.04.278

"(1) The select committee on pension policy may form three function-specific subcommittees, as set forth under subsection (2) of this section, from the members under RCW 41.04.276(1) (a) through (e), as follows:

"(a) A public safety subcommittee with one member from each group under RCW 41.04.276(1) (a) through (e);

(b) An education subcommittee with one member from each group under RCW 41.04.276(1) (a) through (e); and

(c) A state and local government subcommittee, with one retiree member under RCW 41.04.276(1)(d) and two members from each group under RCW 41.04.276(1) (a) through (c) and (e).

The retiree members may serve on more than one subcommittee to ensure representation on each subcommittee."

"(2)(a) The public safety subcommittee shall focus on pension issues affecting public safety employees who are members of the law enforcement officers' and fire fighters' and Washington state patrol retirement systems.

(b) The education subcommittee shall focus on pension issues affecting educational employees who are members of the public employees', teachers', and school employees' retirement systems.

(c) The state and local government subcommittee shall focus on pension issues affecting state and local government employees who are members of the public employees' retirement system."

RCW 41.04.281

"The select committee on pension policy shall has the following powers and duties:

"(1) Study pension issues, develop pension policies for public employees in state retirement systems, and make recommendations to the legislature;

(2) Study the financial condition of the state pension systems, develop funding policies, and make recommendations to the legislature;

(3) Consult with the chair and vice-chair on appointing members to the state actuary appointment committee upon the convening of the state actuary appointment committee established under RCW 44.44.013; and

(4) Receive the results of the actuarial audits of the actuarial valuations and experience studies administered by the pension funding council pursuant to RCW 41.45.110. The select committee on pension policy shall study and make recommendations on changes to assumptions or contribution rates to the pension funding council prior to adoption of changes under RCW 41.45.030. 41.45.035, or 41.45.060."

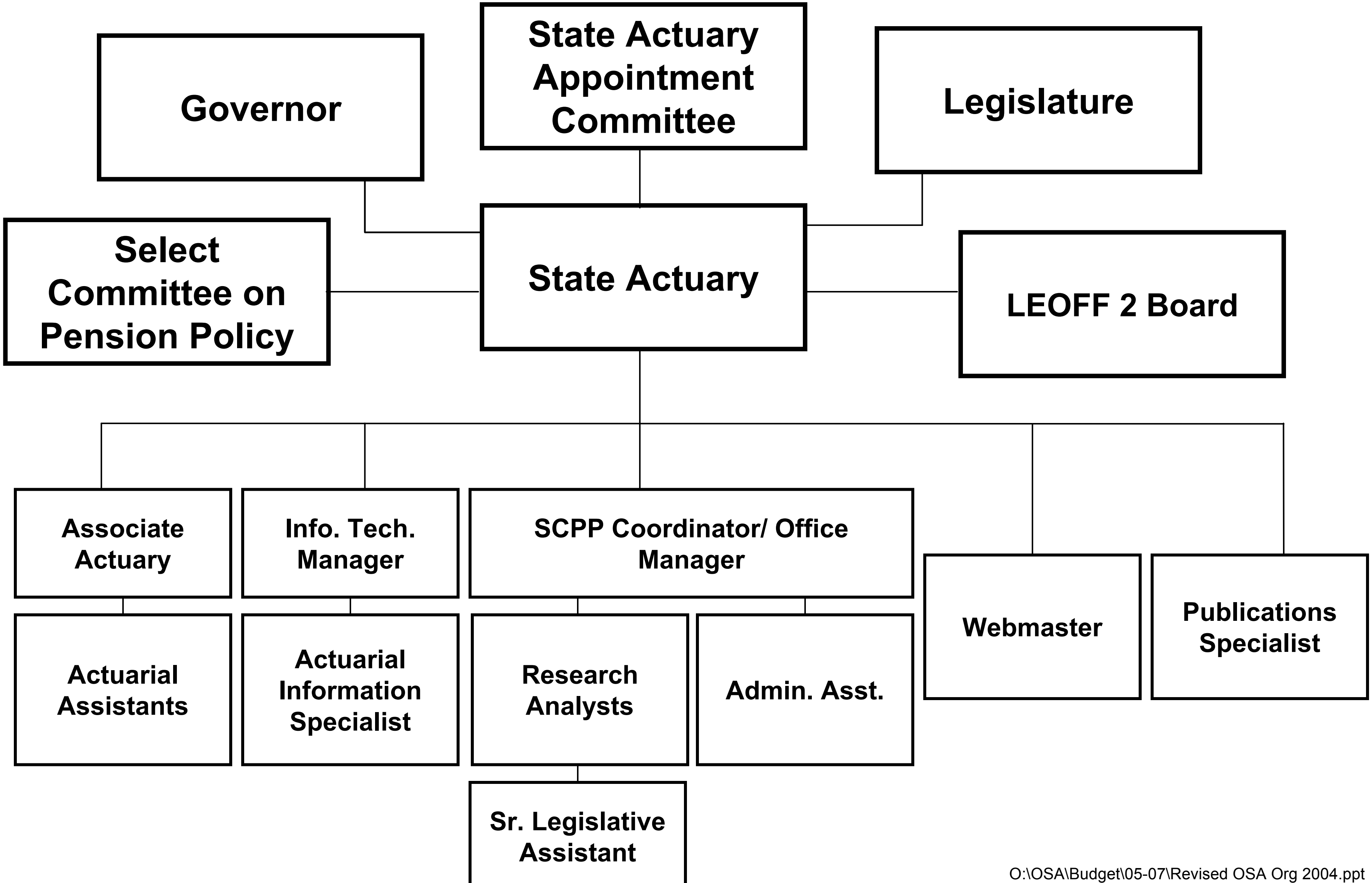
The present members of the Select Committee on Pension Policy are:

Representative Gary Alexander
Elaine M. Banks, TRS Retirees
Marty Brown, Director, Office of Financial Management*
Senator Don Carlson
John Charles, Director, Department of Retirement Systems
Representative Steve Conway, Vice Chair*
Representative Larry Crouse
Senator Karen Fraser, Chair*
Representative Bill Fromhold
Leland A. Goeke, TRS and SERS Employers*
Bob Keller, PERS Actives
Corky Mattingly, PERS Employers
Doug Miller, PERS Employers
Glenn Olson, PERS Employers
Diane Rae, TRS Actives
Senator Debbie Regala
J. Pat Thompson, PERS Actives
David Westberg, SERS Actives*

* Member of the Executive Committee

O:\OSA\BUDGET\05-07\TEXT.wpd

Office of the State Actuary



State of Washington

Recommendation Summary

Agency: 035

11:16:33AM
7/29/2004

Dollars in Thousands

	Annual Average FTEs	General Fund State	Other Funds	Total Funds
2003-05 Current Biennium Total	**11.5**		**2,645**	**2,645**
CL 8I Self Insurance CF				
CL 8K Health Benefits CF			10	10
CL 9N Contractual Obligation Adj			30	30
CL 9Y Other ML Adjustments			15	15
Total Carry Forward Level	**11.5**		**2,700**	**2,700**
Percent Change from Current Biennium			2.1%	2.1%
Carry Forward plus Workload Changes	**11.5**		**2,700**	**2,700**
Percent Change from Current Biennium			2.1%	2.1%
M2 8X Self Insurance Premiums			(6)	(6)
M2 YY Merit Pay Increases			51	51
Total Maintenance Level	**11.5**		**2,745**	**2,745**
Percent Change from Current Biennium			3.8%	3.8%
PL AA Business Plan Consultant			8	8
PL BB Actuarial Valuation System			200	200
PL CC Publications Specialist	1.0		181	181
Subtotal - Performance Level Changes	**1.0**		**389**	**389**
2005-07 Total Proposed Budget	**12.5**		**3,134**	**3,134**
Percent Change from Current Biennium	8.7%		18.5%	18.5%

M2 8X Self Insurance Premiums

Decrease in Risk Management Premiums

M2 YY Merit Pay Increases

Funding is requested for annual merit pay increases consistent with legislative policy and procedures.

PL AA Business Plan Consultant

Funding is requested to hire a consultant to assist the Select Committee on Pension Policy develop a Business Plan.

PL BB Actuarial Valuation System

Funding is requested to replace the actuarial valuation software.

PL CC Publications Specialist

Funding is requested for a Publications Specialist position to continue our emphasis on improved communications and to assist with workload increases resulting from support of the newly-created Select Committee on Pension Policy.

State of Washington
Decision Package

DRAFT

Agency: **035 Office of State Actuary**

Decision Package Code/Title: **8X Self Insurance Premiums**

Budget Period: **2005-07**
Budget Level: **M2 - Inflation and Other Rate Changes**

Recommendation Summary Text:

Decrease in Risk Management Premiums

Fiscal Detail

Operating Expenditures	FY 2006	FY 2007	Total
600-1 Dept of Retirement Systems Expense-State	(3,521)	(2,508)	(6,029)
Total Cost	**(3,521)**	**(2,508)**	**(6,029)**

Package Description:

Reflects a decrease in risk management premium for 05-07.

Narrative Justification and Impact Statement

How contributes to strategic plan:

Performance Measure Detail

Activity:

Incremental Changes

No measures submitted for package

Reason for change:

Per Office of Financial Management Direction.

Impact on clients and services:

Impact on other state programs:

Relationship to capital budget:

Required changes to existing RCW, WAC, contract, or plan:

Alternatives explored by agency:

Budget impacts in future biennia:

Distinction between one-time and ongoing costs:

Effects of non-funding:

Expenditure Calculations and Assumptions:

Expenditure data provided by OFM Risk Management Division.

Object Detail		FY 2006	FY 2007	Total
E	Goods And Services	(3,521)	(2,508)	(6,029)

State of Washington
Decision Package

DRAFT

Agency:	**035 Office of State Actuary**
Decision Package Code/Title:	**YY Merit Pay Increases**
Budget Period:	**2005-07**
Budget Level:	**M2 - Inflation and Other Rate Changes**

Recommendation Summary Text:

Funding is requested for annual merit pay increases consistent with legislative policy and procedures.

Fiscal Detail

Operating Expenditures	FY 2006	FY 2007	Total
600-1 Dept of Retirement Systems Expense-State	17,794	33,564	51,358
Total Cost	**17,794**	**33,564**	**51,358**

Package Description:

It is the long-term practice of the Legislative Branch to provide annual pay increases to staff based upon job performance. Funding these increases from current level funding is a hardship for small agencies.

Narrative Justification and Impact Statement

How contributes to strategic plan:

Performance Measure Detail

Activity:

Incremental Changes

No measures submitted for package

Reason for change:

Impact on clients and services:

None

Impact on other state programs:

None

Relationship to capital budget:

None

Required changes to existing RCW, WAC, contract, or plan:

None

Alternatives explored by agency:

None

Budget impacts in future biennia:

On-going cost

Distinction between one-time and ongoing costs:

On-going

Effects of non-funding:

Cost would be absorbed by agency, reducing funds available to continue current activities.

Expenditure Calculations and Assumptions:

Employees will receive a 2.5% pay increase in Fiscal years 2006 and 2007.

Object Detail		FY 2006	FY 2007	Total
A	Salaries And Wages	17,453	31,842	49,295
B	Employee Benefits	341	1,722	2,063
Total Objects		**17,794**	**33,564**	**51,358**

DRAFT

Agency:	**035 Office of State Actuary**
Decision Package Code/Title:	**AA Business Plan Consultant**
Budget Period:	**2005-07**
Budget Level:	**PL - Performance Level**

Recommendation Summary Text:

Funding is requested to hire a consultant to assist the Select Committee on Pension Policy develop a Business Plan.

Fiscal Detail

Operating Expenditures	FY 2006	FY 2007	Total
600-1 Dept of Retirement Systems Expense-State	7,500		7,500
Total Cost	**7,500**		**7,500**

Package Description:

The Select Committee on Pension Policy identified a need to develop a Business Plan using an outside individual to coordinate and facilitate the process.

Narrative Justification and Impact Statement

How contributes to strategic plan:

Performance Measure Detail

Activity:

Incremental Changes

No measures submitted for package

Reason for change:

The Select Committee on Pension Policy was established in 2003. The committee members are establishing a new process for setting policy, developing a study plan, and adopting recommendations. Developing a Business Plan is a major part of the process.

Impact on clients and services:

Allows committee members to work together more cohesively.

Impact on other state programs:

None

Relationship to capital budget:

None

Required changes to existing RCW, WAC, contract, or plan:

None

Alternatives explored by agency:

None

Budget impacts in future biennia:

None

Distinction between one-time and ongoing costs:

One-time

Effects of non-funding:

Business Plan would not be developed or would be developed without facilitation.

Expenditure Calculations and Assumptions:

Five days at $1,500 per day.

Object Detail		FY 2006	FY 2007	Total
C	Personal Service Contracts	7,500		7,500

State of Washington
Decision Package

DRAFT

Agency:	**035**	**Office of State Actuary**
Decision Package Code/Title:	**BB**	**Actuarial Valuation System**
Budget Period:	**2005-07**	
Budget Level:	**PL - Performance Level**	

Recommendation Summary Text:

Funding is requested to replace the actuarial valuation software.

Fiscal Detail

Operating Expenditures		**FY 2006**	**FY 2007**	**Total**
600-1	Dept of Retirement Systems Expense-State	100,000	100,000	200,000
	Total Cost	**100,000**	**100,000**	**200,000**

Package Description:

The Office of the State Actuary is seeking new actuarial software to improve the valuation system.

Narrative Justification and Impact Statement

How contributes to strategic plan:

Performance Measure Detail

Activity:

Incremental Changes

No measures submitted for package

Reason for change:

Current 30-year-old system is outdated and includes unsupported components.

Impact on clients and services:

The new system would make current services more efficient and allow a broader range of actuarial services.

Impact on other state programs:

None

Relationship to capital budget:

None

Required changes to existing RCW, WAC, contract, or plan:

None

Alternatives explored by agency:

Office of the State Actuary considered developing new software entirely in house using existing staff and resources.

Budget impacts in future biennia:

On-going cost

Distinction between one-time and ongoing costs:

On-going

Effects of non-funding:

Failure to secure funding would severely limit Office of the State Actuary's ability to obtain commercially available software and may require Office of the State Actuary to undertake an extensive in-house software development effort at the expense of existing client services.

Expenditure Calculations and Assumptions:

Includes either purchase or lease of software and associated system maintenance costs.

Object Detail		**FY 2006**	**FY 2007**	**Total**
J	Capital Outlays	100,000	100,000	200,000

State of Washington

Decision Package

DRAFT

Agency: 035 Office of State Actuary

Decision Package Code/Title: CC Publications Specialist

Budget Period: 2005-07

Budget Level: PL - Performance Level

Recommendation Summary Text:

Funding is requested for a Publications Specialist position to continue our emphasis on improved communications and to assist with workload increases resulting from support of the newly-created Select Committee on Pension Policy.

Fiscal Detail

Operating Expenditures		FY 2006	FY 2007	Total
600-1	Dept of Retirement Systems Expense-State	93,073	87,517	180,590
	Total Cost	**93,073**	**87,517**	**180,590**

Staffing	FY 2006	FY 2007	Annual Average
FTEs	**1.0**	**1.0**	**1.0**

Package Description:

Enhanced communications emphasis and Select Committee on Pension Policy support has resulted in increased workload and pressure on existing staff. The proposed Publication Specialist position would take over office publications and back up the Webmaster by maintaining our new Office of the State Actuary and Select Committee on Pension Policy web sites.

Narrative Justification and Impact Statement

How contributes to strategic plan:

Performance Measure Detail

Activity:

Incremental Changes

No measures submitted for package

Reason for change:

Workload has increased as a result of enhanced communications activities and Select Committee on Pension Policy support.

Impact on clients and services:

None

Impact on other state programs:

None

Relationship to capital budget:

None

Required changes to existing RCW, WAC, contract, or plan:

None

Alternatives explored by agency:

None

Budget impacts in future biennia:

On-going cost

Distinction between one-time and ongoing costs:

On-going

Effects of non-funding:

The communications plan would not be implemented.

Expenditure Calculations and Assumptions:

Assumes a full time FTE with a salary of $69,756 per year. Also includes an estimate for equipment, travel, goods and services related to adding an additional FTE.

Object Detail

		FY 2006	FY 2007	Total
A	Salaries And Wages	69,756	69,756	139,512
B	Employee Benefits	13,621	13,621	27,242
E	Goods And Services	2,358	2,358	4,716
G	Travel	1,782	1,782	3,564
J	Capital Outlays	5,556		5,556
Total Objects		**93,073**	**87,517**	**180,590**

WASHINGTON STATE LEGISLATURE
Office of the State Actuary

August 30, 2004

TO: Select Committee on Pension Policy

FROM: Laura C. Harper, Senior Research Analyst/Legal

SUBJECT: **REVISED GAIN-SHARING REPORT, AUGUST 30, 2004**

At the August 17, 2004 meeting of the SCPP, you received the Gain-Sharing Report dated August 10, 2004 as background information for your initial work-session on gain-sharing. As mentioned in the August 10th report, the funding methodology and materiality of gain-sharing provisions have been under review by the Office of the State Actuary since the last actuarial valuation. Also, as mentioned in the oral presentation, this methodology was (at that time) still under review by the actuarial auditor. In response to the actuarial audit, the OSA's estimated fiscal impact of gain-sharing has been adjusted to reflect higher estimated costs than were originally submitted to you at your August 10, 2004 work session. The revised tables reflecting these adjustments are found on pages 8 and 9 of the August 26, 2004 Revised Gain-Sharing Report, which is attached.

The revised report also contains certain clarifications relating to the graphs on page 10 of the report. These clarifications can be found in the paragraphs preceding and following the graphs on pages 9 and 11. The graphs were intended to generally illustrate the impacts of improving benefits in amounts equal to all of the extraordinary gains (i.e., those exceeding an average compound rate of return on pension fund assets of 10% over the previous four state fiscal years). The text of the report erroneously described the graphs as representing the existing gain-sharing program. As you know, the existing gain-sharing program improves benefits based on an amount equal to only one-half of the extraordinary gains, which are calculated only every other year. The revised report clarifies the actual intent of the graphs as they were used for illustrative purposes during the oral presentation - that is to show how allocating all of the extraordinary gains to something other than offsetting losses would generally lower the rate of return.

2100 Evergreen Park Drive S.W., Suite 150
P.O. Box 40914
Olympia, WA 98504-0914
(360) 753-9144
FAX: (360) 586-8135
TDD: 1-800-635-9993
E-MAIL: actuary_st@leg.wa.gov

A further technical clarification was made on page 12 in the paragraph immediately following the graphs. The revision deletes the reference to real estate as a volatile asset class due to the fact that real estate is a small part of the portfolio and is only valued when it is appraised; therefore, it does not actually contribute to higher volatility in the portfolio at large in the way that other asset classes such as public and private equity would.

If you have any questions about these revisions, please feel free to contact me or Matt Smith, the State Actuary.

O:\SCPP\2004\9-7-04 Full\Memo Gain-Sharing Rev Rpt.wpd

Gain-Sharing

(Revised Draft Report - August 30, 2004)

Issue

Gain-sharing was first implemented in 1998, based on certain assumptions, goals, and policies. This issue paper examines those assumptions, goals and policies in light of the impacts and experience of gain-sharing over the last five years. This report also explores some of the legal, technical and actuarial issues associated with gain-sharing. The report is intended as an overview as well as a tool for evaluating the gain-sharing provisions in current law.

Staff

Laura C. Harper, Sr. Research Analyst/Legal
360-586-7616

Members Impacted

Gain-sharing directly affects retired members of TRS and PERS Plans 1. As of the most recent actuarial valuation (2002), there were 33,148 retirees in TRS 1 and 54,006 retirees in PERS 1. Gain-sharing also affects term-vested, active and retired members of the TRS, SERS and PERS Plans 3. "Term-vested" members are those who left employment, were vested, and who did not withdraw their contributions. As of the most recent actuarial valuation, TRS 3 had 2,151 term-vested members, 45,798 active members and 283 retirees; SERS 3 had 1,148 term-vested members, 26,921 active members, and 185 retirees; and PERS 3 had 198 term-vested members, 15,509 active members and 9 retirees. Plan 2 members do not participate in gain-sharing.

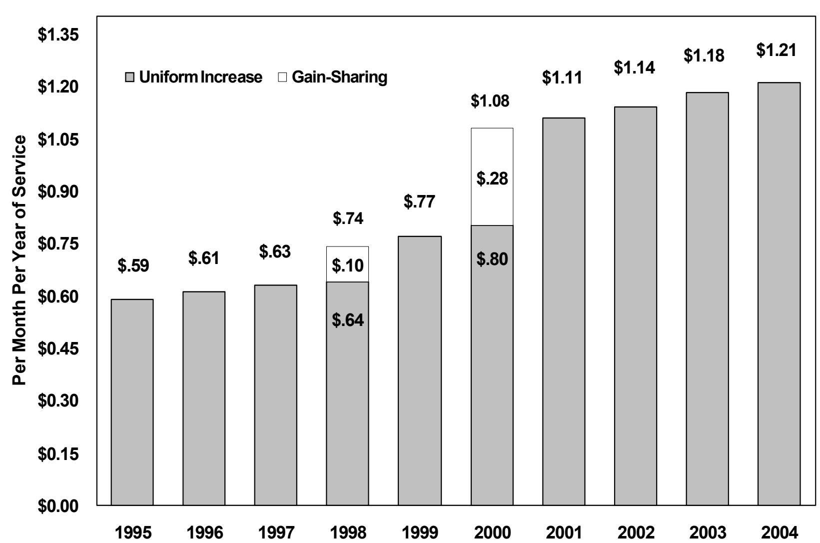
Current Situation

Gain-sharing is a mechanism that increases benefits in PERS 1, TRS 1 and all the Plans 3 (TRS 3, SERS 3 and PERS 3). These increases are not automatic, but are contingent on the occurrence of "extraordinary investment gains." Extraordinary investment gains occur when the compound average of investment returns on pension fund assets exceeds 10% for the previous four state fiscal years. The "compound average" recognizes the affect of compound interest. (Compound interest is interest paid on previously earned interest as well as on the principal.)

When the previous four-year compound average investment return exceeds 10%, a calculation is performed to determine a dollar amount that will be distributed to eligible members. Gain-sharing calculations are currently made once each biennium with potential distributions occurring in January of even-numbered years.

Plan 1 gain-sharing is governed by Chapter 41.31 RCW. As implemented for PERS/TRS 1, an amount equal to one-half of the extraordinary investment returns is used to permanently boost the Annual Increase Amount used in calculating the Uniform Cost of Living Adjustment (COLA). The following graph illustrates how gain-sharing distributions have impacted the uniform increase amount.

PERS 1 & TRS 1
Uniform Increase Amount



Plan 3 gain-sharing is governed by Chapter 41.31A RCW. In the Plans 3, active, retired and term-vested members are eligible for gain-sharing distributions. Distributions are made as a lump sum dollar amount that is deposited directly into member's defined contribution account based on years of service credit. The same 10% rate of return in used to determine when extraordinary gains have occurred. A second calculation is then made to determine the dollar amount to be distributed to eligible members. Eligible Plan 3 members' service is divided by all system members' service. This produces the percentage of Plan 2/3 retirement funds which can be attributed to Plan 3 members' service. The Plan 3 percentage is then multiplied by one-half of the dollar amount of extraordinary gains. The Department of Retirement Systems then deposits a fixed dollar amount per year of service to each eligible member.

Example: Plan 3 Gain-sharing Calculation for Year 2000

Gain Sharing Rate	
1995-1996	17.40%
1996-1997	20.50%
1997-1998	16.60%
1998-1999	11.90%
4 Year Average	16.56%
Gain-sharing %	6.56%
Years of Service (YOS) for Eligible Plan 3 Members	286,702.27
Years of Service for Other Members	1,518,868.57
Total YOS	1,805, 570.84
Ratio of Plan 3 to Total (rounded)	15.88%
Total Gain-Sharing Potential	$458,990,372
Gain-sharing Plan 3	$72,887,671
Gain-sharing per Plan 3 YOS	$254.23

History

Legislation

Gain-sharing legislation was first passed in **1998**. At that time, the Washington State Retirement Systems had been experiencing high rates of returns on plan assets. ESHB 2491 (Chapter 340, Laws of 1998) became effective immediately and established gain-sharing for the PERS and TRS Plans 1. The first gain-sharing distribution was scheduled for July 1, 1998.

SSB 6306 (Chapter 341, Laws of 1998) established gain-sharing for the TRS and SERS Plans 3. The TRS 3 provisions took effect immediately and the SERS provisions were to become effective on September 1, 2000 with the creation of SERS. SERS members would receive retroactive gain-sharing on March 1, 2001, based upon service credit accumulated as of August 1997. A second gain-sharing calculation for SERS 3 members was scheduled for March 2001, based upon service credit accumulated as of August 1999.

HB 1023 (Chapter 223, Laws of **1999**) addressed a technical correction to TRS 3 gain-sharing provisions that had passed in the previous legislative session. The 1999 law was designed to allow most TRS 3 members who had transferred from TRS 2 to TRS 3 to receive gain-sharing distributions as intended by the legislature in 1998.

In the year **2000**, ESSB 6530 (Chapter 247, Laws of 2000) created the PERS 3 gain-sharing provisions, which were the same as had been previously provided to TRS 3 and SERS 3. PERS Plan 3 was to become effective on March 1, 2002. The first gain-sharing payment was to be made March 1, 2003, and would be equal to the gain-sharing payments made to TRS Plan 3 members in January 2000.

2003 legislation affecting gain-sharing provisions involved only certain technical corrections involving statutory cross-references. Other non-SCPP bills have been introduced to: increase the frequency of gain-sharing distributions; change the definition of "extraordinary gains" by lowering the interest rate threshold from 10% to 8%; provide for lump sum payments in lieu of Plan 1 COLA increases; distribute gain-sharing to retirees based upon a point system (1 point for each year of service credit and 2 points for each year of retirement); and apply gain-sharing to members of LEOFF Plan 2. None of the non-SCPP bills concerning gain-sharing have passed.

Historical gain-sharing

The following table summarizes past gain-sharing distributions to members of the Plans 1 and 3:

Historical Gain-sharing (Dollars in Millions)

Distribution Date	PERS1/TRS 1	TRS 3*	SERS 3**	PERS 3***
7/1/1998	$290	$28		
1/1/2000	$634	$73	$50	$26

* TRS 3 members received both 1998 and 2000 gain-sharing distributions. Payments were not retroactive.
**SERS 3 members received both 1998 and 2000 gain-sharing distributions. Payments were retroactive. The total for both distributions is reflected in the 1/1/2000 row.
***PERS 3 members received gain-sharing for 2000 only. Payments were retroactive.

The total dollars spent for benefit improvements in the past two gain-sharing distributions was roughly $1.1 billion. These distributions do not include dollars allocated to shorten the amortization period for the Plans 1. Those dollars amounted to another $290 million in 1998 and $634 million in 2000 for a grand total of roughly $2 billion. In 2001, however, the Plan 1 payoff date was extended back out to 2024, the same as it was prior to gain-sharing. The benefit enhancements and the adjustments to the Plan 1 amortization period are described in more detail below.

Policy Analysis

The original gain-sharing mechanism was developed within a framework of Joint Committee on Pension Policy goals. The goals for gain-sharing included:

1. An on-going process that is understandable, stable, and would take place with meaningful frequency.
2. No additional unfunded long-term liabilities.
3. Immediate benefit improvements funded by recent investment gains.
4. Future benefit improvements whenever the assets invested in the retirement trust accounts experience extraordinary gains.
5. An acceleration of the date for paying off the unfunded actuarial liability of PERS 1 and TRS 1.

It was also expected that funding benefit improvements when there are extraordinary investment returns gains would decrease the effect of those returns on employer contribution rates. In other words, it was expected that employer contribution rates would not flatten or be driven downward if the gains triggered benefit improvements and reductions of the Plan 1 unfunded liabilities. See Gain Sharing, Report to the Joint Committee on Pension Policy, January 13, 1998. This approach seemed to assume that future employer rates would be set in response to market forces. They would go down when markets are good, and back up when markets are bad. While legislatures may choose to set contribution rates on an ad hoc basis, there are other ways to address contribution rate-setting. See Contribution Rate Setting, July 2, 2004 Report to the SCPP by the State Actuary.

This policy analysis will compare these goals to the experience of the last five years. This section of the report will also explore some of the technical/legal and actuarial constraints that affect gain-sharing.

Goal 1: An ongoing process that is understandable, stable, and would take place with meaningful frequency.

Gain-sharing is ongoing in the sense that it is a benefit enhancement that has been built into the affected plans through the mechanism of pension plan amendments. These plan amendments require that gain-sharing distributions be made in the future whenever certain specified conditions are met. The gain-sharing provisions are, however, subject to a "no contractual right" clause. This clause states that "no member or beneficiary has a contractual right to receive this distribution not granted prior to that time." These kinds of clauses have not been tested in the Washington courts. This legal uncertainty lends an aspect of unpredictability to the gain-sharing benefit.

Gain-sharing distributions have been triggered in two instances in the last five years. The first distribution occurred on July 1, 1998. Thereafter, gain-sharing distributions were to occur on January 1st of even-numbered years, assuming that the affected plans experienced extraordinary investment returns. The second distribution was triggered for January 1, 2000. On January 1 of 2002 and 2004, there were no extraordinary investment returns available to trigger a gain-sharing distribution.

The frequency of gain-sharing in the future is tied to annual investment returns, which are unpredictable. When gain-sharing legislation was passed in 1998, it was estimated that the 10% threshold for distribution of extraordinary gains would have been exceeded in 21 of the past 34 biennia. However, the past is not necessarily a predictor of the future. While the trigger mechanism for gain-sharing is fixed, the incidence of future gain-sharing is unknown.

In summary, the frequency of future gain-sharing is:

– subject to legal uncertainty;
– unpredictable due to market fluctuations.

Goal 2: No additional unfunded long-term liabilities.

At its inception, gain-sharing was almost viewed as a "no cost" item, i.e. it would only occur when times were good, and it would simply keep employer contribution rates from going down during those good times. In addition, the law has not allowed for any adjustment to the **supplemental** contribution rate for gain-sharing. See RCW 41.45.070(7). The supplemental rate is a temporary contribution rate increase that is made to reflect the cost of benefit changes until those changes can be included in the next actuarial valuation.

The future cost of the gain-sharing benefit provisions of PERS and TRS Plans 1, and PERS, TRS and SERS Plans 3 was not reflected in the 2002 actuarial valuation. However, the actuarial certification in the 2002 Actuarial Valuation Report noted that the funding methodology and materiality of the gain-sharing provisions were under review. Such review is required by the Actuarial Standards of Practice promulgated by the American Academy of Actuaries. (See Standards 4 and 27.) These standards require that material liabilities of the plan be identified so they can be "pre-funded." The State Actuary is now identifying gain-sharing as a material liability due to the future cost associated with this benefit, and this liability will be reflected in the 2003 Actuarial Valuation.

Estimated Fiscal Impact of Future Gain-Sharing

Future gain-sharing will impact the actuarial funding of the systems by increasing the present value of benefits payable under the systems and the required actuarial contribution rates as shown below:

(Dollars in Millions)		Current	Increase	Total
Actuarial Present Value of Projected Benefits (The Value of the Total Commitment to all Current Members)	PERS 1	$12,715	$504	$13,219
	PERS 2/3	14,159	119	14,278
	TRS 1	10,341	426	10,767
	TRS 2/3	4,876	344	5,220
	SERS 2/3	1,979	159	2,138
Unfunded Actuarial Accrued Liability (The Portion of the Plan 1 Liability that is Amortized at 2024)	PERS 1	$2,123	$497	$2,620
	TRS 1	1,012	404	1,416

Increase in Contribution Rates: (Effective 2005)	**PERS**	**SERS**	**TRS**
Employee	0.00%	0.00%	0.00%
Employer State	0.65%	2.35%	2.01%

Fiscal Budget Determinations

As a result of the higher required contribution rates, the increase in funding expenditures is projected to be:

(Dollars in Millions)	PERS	SERS	TRS	Total
2005-2007				
State:				
General Fund	$19.8	$31.7	$122.7	$174.2
Non-General Fund	32.6	0.0	0.0	32.6
Total State	**$52.4**	**$31.7**	**$122.7**	**$206.8**
Local Government	46.6	28.0	25.2	99.8
Total Employer	99.0	59.7	147.9	306.6
Total Employee	$0.0	$0.0	$0.0	$0.0
2007-2009				
State:				
General Fund	$24.1	$41.1	$150.9	$216.1
Non-General Fund	39.9	0.0	0.0	39.9
Total State	**$64.0**	**$41.1**	**$150.9**	**$256.0**
Local Government	56.7	36.4	30.9	124.0
Total Employer	120.7	77.5	181.8	380.0
Total Employee	$0.0	$0.0	$0.0	$0.0

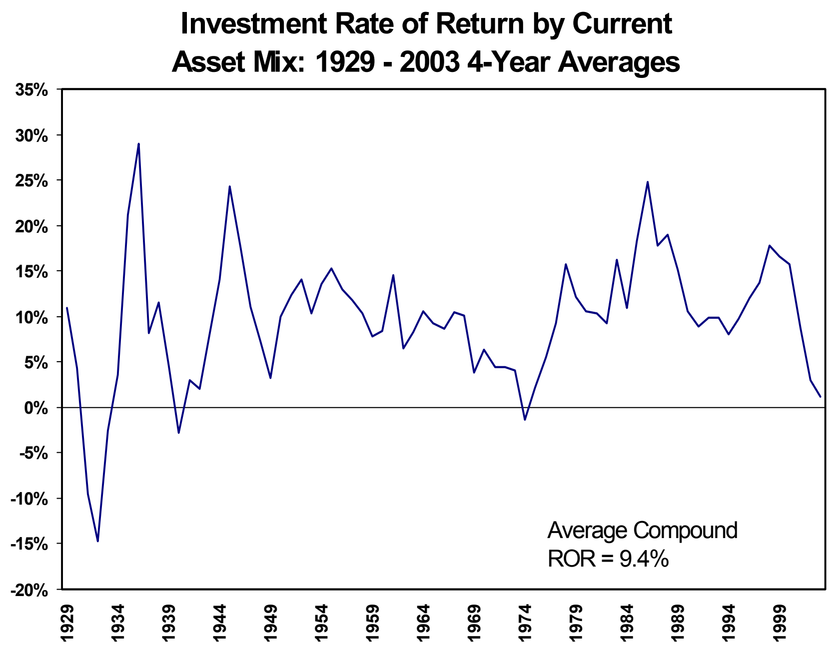
(Dollars in Millions)	PERS	SERS	TRS	Total
2005-2030				
State:				
General Fund	$426.5	$912.6	$2,857.2	$4,196.3
Non-General Fund	703.5	0.0	0.0	703.5
Total State	**$1,130.0**	**$912.6**	**$2,857.2**	**$4,899.8**
Local Government	1,002.5	808.8	585.0	2,396.3
Total Employer	2,132.5	1,721.4	3,442.2	7,296.1
Total Employee	$0.0	$0.0	$0.0	$0.0

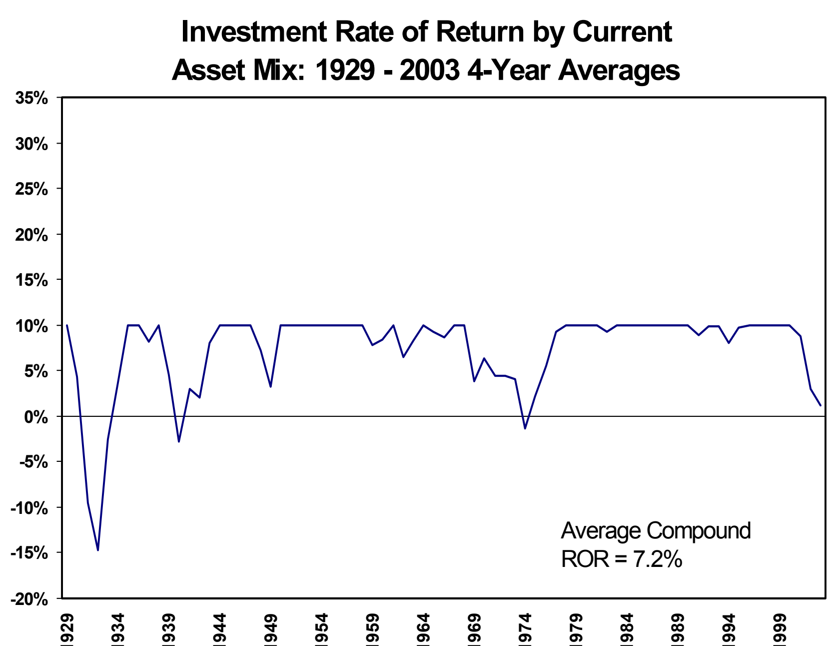
The costs presented in this estimate are based on our understanding of existing gain-sharing provisions as well as generally accepted actuarial standards of practice including the following:

1. *Costs were developed using the same membership data, methods, assets and assumptions as those used in preparing the September 30, 2003 draft actuarial valuation report of the Retirement Systems.*
2. *As with the costs developed in the actuarial valuation, the emerging costs of the systems will vary from those presented in the valuation report or any fiscal note to the extent that actual experience differs from that projected by the actuarial assumptions.*
3. *The funding method used for Plan 1 utilizes the Plan 2/3 employer/state rate as the Normal Cost and amortizes the remaining liability (UAAL) by the year 2024. Benefit increases to Plan 2/3 will change the UAAL in Plan 1. The cost of benefit increases to Plan 1 increases the UAAL.*
4. *Plan 2/3 utilizes the Aggregate Funding Method. The cost of Plan 2/3 is spread over the average working lifetime of the current active Plan 2/3 members.*
5. *The employee/employer level of cost-sharing as defined in the actuarial funding chapter - Chapter 41.45 RCW - provides that the cost of Plan 3 benefit enhancements is shared equally among Plan 2/3 employers and Plan 2 employees.*

Under current law, extraordinary gains are determined every other year, and an amount equal to one-half of the extraordinary gains is distributed for benefit improvements. However, proposals have been made to increase the amount and frequency of gain-sharing. The estimated cost of reserving all of the extraordinary gains for benefit improvements can be illustrated by the following charts, which show the effects on investment returns. The first graph shows the 4-year average compound rate of return (ROR) using today's retirement plan asset mix as spread over the 1929 to 2003 period, which yields a 9.4% rate of return. (Currently, the assumed actuarial rate of return is 8%.)* The second graph shows the 4-year average compound rate of return using the same asset mix over the same period, but with all of the extraordinary gains being allocated to benefit improvements. The full appropriation of extraordinary gains lowers the rate of return from approximately 9.4% to 7.2%.**

**The graphs on page 10 are for illustrative purposes only. It is not appropriate to use them for setting the assumed investment rate of return for purposes of the actuarial valuation. For additional information on setting the assumed investment rate of return, see letter from the State Actuary to the Pension Funding Council dated May 25, 2004.*
*** The graphs on page 10 are for illustrative purposes only and were not used to develop the estimated fiscal impacts of future gain-sharing.*


Investment Rate of Return by Current
Asset Mix: 1929 - 2003 4-Year Averages
35%
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1929
1934
1939
1944
1949
1954
1959
1964
1969
1974
1979
1984
1989
1994
1999
Average Compound
ROR = 9.4%


Investment Rate of Return by Current
Asset Mix: 1929 - 2003 4-Year Averages
35%
30%
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
1929
1934
1939
1944
1949
1954
1959
1964
1969
1974
1979
1984
1989
1994
1999
Average Compound
ROR = 7.2%

The second graph illustrates the scenario in which the "peaks" of investment returns (i.e. those in excess of 10%) have been "skimmed." The average compound rate of return is lowered because the peaks are no longer available to offset the "valleys" or low periods of investment returns. The valleys remain the same, while the peaks are "lopped off." This pattern could change depending on the asset allocation policy of the Washington State Investment Board. For example, if allocations to certain high-volatility asset classes such as public and private equity were reduced in the portfolio, there could be fewer instances of "extraordinary gains."

An original goal of gain-sharing was "no additional unfunded liabilities." However due to the fact that future gain-sharing distributions have not been pre-funded, gain-sharing has significantly increased the unfunded long-term liabilities of the affected plans.

Goal 3: Immediate benefit improvements funded by recent investment gains.

The gain-sharing legislation for the Plans 1 became effective immediately and thus resulted in immediate benefit improvements. The first gain-sharing distribution in 1998 provided a $.10 increase in the Annual Increase Amount used to calculate the Uniform COLA. The Uniform COLA provides a cost-of-living adjustment to Plan 1 retirees beginning at age 66 based on the retiree's service credit. The Uniform COLA began in 1995 at $.59 per month per year of service credit and increases 3% annually. When gain-sharing was passed in 1998, the Uniform COLA was at $.63 per month per year of service. The $.10 increase was permanent and is part of the base for determining the regular annual increases.

The 1998 gain-sharing distribution also paid the actuarial present value (using a one-time payment) of a retroactive "pop-up" benefit for retirees who retired prior to 1996 and elected a survivor benefit. The "pop-up" provided that if the retiree is predeceased by the beneficiary, the retiree's benefit is restored to its unreduced level at the beginning of the month following the death of the beneficiary. Those retirees who had already been predeceased by their beneficiaries had their benefits restored on the effective date of the act (July 1, 1998). The one-time cost of providing this benefit was $52 million.

The 1998 gain-sharing distribution to Plan 3 members was $134.43 per year of service credit. The gain-sharing amounts were distributed as lump sums deposited into Plan 3 members' defined contribution accounts.

Were these benefit improvements "funded by" recent investment gains? As explained when gain-sharing was first proposed, there are two primary methods for funding benefit improvements: a contribution rate increase, or a present-value payment. A contribution rate increase pays off the cost of the new benefit over time. A present-value payment is a one-time payment into the retirement system to cover all the estimated future costs of the benefit.

Past gain-sharing distributions resulted in transfers from the retirement trust accounts to individual members. Significant dollars were paid out of the retirement system. Past gain-sharing benefits were paid for in the sense that employer contribution rates stayed at a higher level than they would have absent gain-sharing. However no mechanism was established to pay for future gain-sharing. Many have assumed that the "extraordinary gains" somehow pay for the benefits. However "extraordinary gains" are simply the market events that triggered the timing of benefit improvements. Their long-term cost must be funded by either higher contribution rates or appropriations of new money into the retirement system.

In thinking about the fact that gain-sharing itself is not a funding mechanism for future benefit improvements, it may be useful to compare extraordinary investment gains with actuarial gains. Actuarial gains are generated by favorable plan experience. In other words, when a retirement plan is funded based on certain assumptions (including the assumed rate of investment return and various demographic assumptions) that are too conservative, it is more likely that the long-term plan experience will be more favorable than the assumptions. Favorable plan experience generates actuarial gains.

When assumptions are not conservative enough, there is less opportunity for favorable plan experience. Without favorable plan experience, there are no gains and there may even be increases in liability. Generally, actuarial assumptions are periodically adjusted to be as consistent as possible with plan experience. Thus, overall, actuarial gains are used to offset actuarial losses, just as investment gains offset investment losses.

When benefit enhancements are funded indirectly though temporary gains and not directly through increased contribution rates or one-time pay-outs, then those gains are no longer available in the future to offset losses. In effect, it is as if the gains have been capped. The approach leads to increased future liabilities. This is not to say that retirement plans never have surpluses which can be used for reasonable benefits enhancements. However, an asset surplus is not the same as a prolonged stock market surge. An asset surplus occurs when all liabilities have been satisfied and there is still money left over. This is not the case in the Plans 1 or the Plans 3; thus benefit improvements still require a funding mechanism that is related to their cost.

In summary, in accordance with its original goals, gain-sharing generated significant immediate benefit improvements upon passage of the initial legislation. Those enhancements, however, were not funded by recent investment gains; rather, the benefit improvements were funded by employer contributions. Similarly, future benefit enhancements that are triggered by gain-sharing events will require additional funding in order to avoid future increases in plan liabilities.

Goal 4: Future benefit improvements whenever the assets invested in the retirement trust accounts experience extraordinary gains.

Looking at the future from the perspective of the Joint Committee on Pension Policy in 1998, we see that the 2000 gain-sharing distribution was much larger than the 1998 distribution. It provided a second permanent increase in the Uniform COLA amount for TRS 1 and PERS 1 of $.28 as of January 1, 2000. Eligible members of the Plans 3 received $254.23 per year of service credit as lump sums deposited into their defined contribution. There were no gain-sharing distributions in 2002 or 2004.

As mentioned before, while the trigger mechanism for gain-sharing is fixed, the incidence of future gain-sharing is unknown. Also, as explained earlier, while gain-sharing provisions trigger certain future benefit payments according to a pre-determined formula that varies with the size of the investment gains, there is no official funding mechanism provided to pay for the resulting benefit improvements that will occur. It is simply assumed that a) gain-sharing will only occur when contribution rates are otherwise decreasing, and b) the distributions will result in employer contribution rates remaining at a higher level than they would have been absent gain-sharing.

Goal 5: An acceleration of the date for paying off the unfunded actuarial liability of PERS Plan 1 and TRS Plan 1.

Accelerating the date for paying off the unfunded actuarial accrued liability (UAAL) has an effect on contribution rates. When the amortization period for plan liabilities is shortened, contribution rates must be higher. When the amortization period is lengthened, contribution rates can be lower. This is similar to a mortgage payment, in that a shorter mortgage period means a higher monthly payment and a longer mortgage period means a lower monthly payment. In PERS 1 and TRS 1, member contribution rates are fixed by statute at 6% of pay. Thus, when contribution rates fluctuate due to a change in the amortization period, it is the employer contribution rate that is adjusted.

The original gain-sharing legislation provided that an amount equal to one-half of the extraordinary investment gains would be used to shorten the amortization period for unfunded liabilities in PERS 1 and TRS 1. This provision of the original gain-sharing legislation was codified in RCW 41.45.060(5). In 1998, the unfunded liability amortization period was rolled back from 2024 to 2022. In 2000, the amortization period was rolled back from 2022 to December 31, 2016. Then in 2001, the provision requiring that gain-sharing distributions be used to pay off the unfunded liability of the Plans 1 dropped out of the law. The amortization period for PERS and TRS Plan 1 unfunded liability was extended back out to 2024.

Currently there is no legal requirement that gain-sharing distributions be used to reduce the unfunded liability of PERS 1 or TRS 1. Furthermore, the scheduled payoff date of June 30, 2024 for Plan 1 liabilities is now the same as it was before gain-sharing.

Policy Constraints

Funding policies in the Actuarial Funding Chapter

The following general funding policies have been adopted for the Washington State Retirement Systems, and are codified in RCW 41.45.010:

1. to continue to fully fund the Plans 2 and 3;
2. to fully amortize the total costs of the Plans 1 by 2024;

3. to establish predictable long-term employer contribution rates which will remain a relatively constant proportion of future state budgets; and
4. to fund benefit increases over the working lives of members so the cost of those benefits are paid by the taxpayers who receive the benefit of those members' service.

Gain-sharing was originally passed to be funded on a pay-as-you-go basis. It was expected that employer contribution rates would simply be kept higher during those times when they would otherwise be going down in response to favorable market returns. Also, the pay-as-you go approach was favored because of difficulties in projecting future gain-sharing events and their attendant liabilities.

Because future gain-sharing benefits have not been pre-funded, gain-sharing may be viewed as inconsistent with the above funding policies. With respect to policy #1, gain-sharing has a significant cost that is not reflected in current employer contribution rates. To that extent it may be said that the Plans 3 are not fully funded. Policy #2 calls for the unfunded liabilities of the Plans 1 to be paid off by 2024. To the extend that gain-sharing provides for permanent future benefit increases that have not been pre-funded, there is the possibility that future gain-sharing would create additional unfunded liability, thereby extending the pay-off date. With respect to policy #3, we know that future gain-sharing events will occur irregularly during the future due to market volatility. If gain-sharing benefits are not pre-funded, then employer contribution rates will be adjusted to accommodate gain-sharing benefits only in response to market fluctuations. It may be said that this type of funding is not predictable or systematic. Finally, due to the unpredictability of gain-sharing events, some generations of taxpayers may be benefitted by gain-sharing distributions more than others, while some may be burdened more than others. If so, the gain-sharing program would be inconsistent with policy #4.

Parity among plans

RCW 41.50.005(1) sets forth as retirement policy that the retirement systems of the state shall provide similar benefits whenever possible. The application of gain-sharing to members is currently very different for the Plans 1, the Plans 2 and the Plans 3 of the Washington State Retirement systems. When gain-sharing distributions are triggered, members of PERS 1 and TRS 1 receive permanent increases through the Uniform COLA, while Plan 3 members receive lump sum distributions into their defined contribution accounts. Plan 2 members to not participate directly in gain-sharing. Theoretically, they participate indirectly by having their contribution rates adjusted (along with that of their employers).

In the Plans 1, members have no control over their contribution rate, which is statutorily set at 6%. In the Plans 3, which are hybrid plans, members decide (from six options) how much they will contribute to the defined contribution portion of their plan. (The Plan 3 defined benefit is employer-provided.) In the Plans 2, member contribution rates change to reflect the cost of the plan.

Theoretically Plan 2 members, like employers, can enjoy lower contribution rates when economic times are good. However, since Plan 2 member contribution rates change to reflect the cost of the plan, their contribution rates are also subject to increase when economic times are bad. In other words, Plan 2 members are sharing in both gains and losses, which offset each other over time under a reasonable set of actuarial assumptions. This is in direct contrast to gain-sharing for members of the Plans 1 and 3, who receive permanent benefit improvements without participating in the offsetting losses.

Federal Law Constraints

Final regulations were effective June 15, 2004 concerning required minimum distributions under Internal Revenue Code Section 401(a)(9). Under these rules, tax benefits that were given during a participant's working years are recaptured from pay-outs during the retirement years. Generally, the rules limit the ability to avoid taxes by "back loading" annuities to pay less in the early years of retirement. In particular, the regulations permit increases in payments solely to reflect better-than-assumed investment performance, e.g. gain-sharing. However, there are specific requirements related to the measurement of actuarial gains from investment experience. These requirements should be reviewed with tax counsel to assure on-going compliance with Section 401(a)(9).

Private Sector Models

In the private sector, many companies provide what is known as "profit sharing." With profit sharing, a company establishes a target profit level. If actual profits exceed the target, then a percentage of the excess is divided among employees. There are several types of profit sharing plans: current distribution (cash) plans, deferred payout plans and combination plans. Under current distribution plans, a profit sharing bonus is paid in cash or in shares. Under deferred payout plans, the profit sharing amount is placed in trust for later payment at termination or retirement. There are also combination or hybrid profit sharing plans that use elements of both current distribution elements and deferred payout elements.

Another form of profit- or gain-sharing is to grant bonuses to employees who generate ideas or take actions that result in cost-savings for their employer. These programs have been used more in the private sector, but have also been used in the public sector to promote government efficiency, for example in Baltimore County, North Carolina and Washington.

Gain-sharing is relatively new in the public sector. According to a nationwide survey by Fox, Lawson & Associates, fewer than 6% of public sector organizations in the United States, from school districts up through state-level organizations, had implemented a gain-sharing program in 1997. This may be explained, in part, by the fact that governmental retirement systems are not funded to generate profits. Public retirement systems are typically funded so that the liabilities of member benefits are completely funded over the working lifetime of the members. If there is a surplus then taxpayers and members have paid too much. If there is unfunded liability that is too large to be amortized over the working lifetime of the members, then taxpayers and members have paid too little. Actuaries assist employers in setting contribution rates that are adequate to address the long-term liabilities of the system.

Cost-sharing

If gain-sharing is not really about sharing in "gains" or "profits," then why do we have gain-sharing? In the context of the Washington State Retirement Systems, gain-sharing is more about cost-sharing than profit sharing. When employer contribution rates are coming down, members with fixed contribution rates may receive benefit improvements in order to share in the reduced costs. Since such members are unable to experience reduced contribution rates based on variations in the market, they can receive benefits improvements of equivalent value.

Conversely, however, when employer contribution rates are going up, Plan 1 and Plan 3 members do not share in the increased costs (or experience plan "losses") for two reasons: first, their contribution rates are fixed, and secondly, as a general matter, permanent benefit increases cannot be subsequently reduced. Therefore, in the Plans 1 and 3, the employer covers all "losses" or increased costs. The contribution rates of Plan 2 members, on the other hand, are subject to increases to cover increased liabilities. Plan 2 members share in both reduced costs and increased costs.

Comparison with Other Retirement Systems

A review of the websites and handbooks for Washington's ten comparative retirement systems revealed three states that have adopted gain-sharing provisions: Colorado, Idaho and Minnesota. In addition, the Retirement Committee for the California Teachers' Association State Council had "gain-sharing ad hoc benefit for retirees" on its list of legislative priorities in 2000 and 2001, but it dropped off the list in 2002. Other systems outside Washington's comparative systems that have enacted gain-sharing (or similar) provisions include Arizona, Louisiana and New York City. The approaches of these systems differ considerably. The following discussion summarizes the gain-sharing experience in several jurisdictions.

Arizona

Arizona passed legislation creating a "Permanent Benefit Increase (PBI) COLA for retirees of the Arizona State Retirement System. Under the PBI, a portion of the investment returns, as measured on the actuarial value of assets, that exceeds 8% is "used" for retiree COLAs. If the retiree liability is one-third of the total liability, then one-third of the excess is "available" for the PBI. The retiree COLA's are paid whenever there is enough "set aside" to fund them. An enhanced PBI COLA is paid to those who retired with a minimum of ten years of service credit and have been retired for five or more years. The intent of the enhanced PBI is to help offset the cumulative effects of inflation since retirement.

The retirement system built up a large reserve in the late 1990's and has been paying 4% COLAs to most retirees since then. However more recently, due to poor investment returns, it is estimated that the reserve will be depleted within the next couple of years. At that point, no COLAs will be given until actuarial returns exceed 8% again. The cost of these benefit increases (COLAs) is added to the existing liabilities of the retirement system. There is no direct recognition of the PBI feature in the actuarial assumptions.

Colorado

Gain-sharing for members of Colorado's Public Employees' Retirement Association (PERA) was designed to allow employees and retirees to share benefits when the retirement plan is over-funded. 50% of over-funding went to active members in the form of a match to contributions to the 401(k) optional plan or to some other employer-sponsored tax-sheltered vehicle. The "Matchmaker" program for active members involved a dollar-for-dollar match of up to 1% of pay. Gain-sharing was also distributed to retirees as a contribution to the heath care trust fund where it could be used to finance increases in a health care subsidy provided to retirees. Matchmaker was suspended by the legislature this year. The Colorado legislature also reduced contributions to the health care trust this year by .08%. Coincidently, the legislature has adopted a plan to gradually increase employer contributions from 9.9% to 12.9% in 2012.

Idaho

The Public Employee Retirement System of Idaho (PERSI) adopted a gain-sharing program in 2000. As part of the program, PERSI established the Choice Plan, a defined contribution (DC) plan for active members. Gain-sharing distributions to active members would be deposited into their DC accounts and retirees would receive a 13th check. PERSI paid a gain-sharing distribution of $155 million to members, retirees and employers in 2001. State employers, however, were directed to return 80% of gain-sharing to the state's general fund; 20% was to be used for training. Other employers used gain-sharing as they saw fit.

Today Idaho is in the process of increasing contribution rates. The increases are being phased in over a three- year period ending in 2006. These increases will bring contribution rates back to their 1997 levels.

Louisiana

Louisiana established an "experience account" to be credited with 50% of the retirement system's net investment experience gain and debited for 50% of the system's net investment losses for each year. The retirement board was required to grant cost-of-living adjustments (COLAs) when the experience balance was sufficient to fund the COLA in full.

The State of Louisiana's Legislative Actuary recommended that the experience account be viewed merely as a temporary holding account, emphasizing that "**it does not fund** COLA benefits." That is because the earnings held in the account are needed to meet the actuarial assumed long-term average return. He asserted that the experience account was just a measuring device that the state could use to grant COLAs.

As explained by Louisiana's actuary, COLAs create an additional benefit liability that increases the unfunded accrued liability. He also pointed out that the key to ultimately achieving the expected return is that all investment income is credited to the asset base from which it is derived. If income is diverted for other purposes the assumed rate will not be achieved. This in turn destroys the required match between future benefit payments and assets available to pay for them. For that reason, the Actuary recommended that additional contributions be made to restore the funding balance between future assets and liabilities, and that contribution rates be independent of the experience account's "interference." See State of Louisiana Legislative Audit, July 2002. The estimated cost of "pre-funding" the Louisiana COLAs was approximately $2.2 billion for teachers and state employees.

Minnesota

The Minnesota State Retirement System (MSRS) currently provides two types of post-retirement adjustments: 1) a cost-of-living adjustment and 2) an investment performance component. Minnesota's gain-sharing is triggered when investment gains averaged over a five-year period exceed a specified amount - that is, the amount to cover the cost-of -living adjustment increase and the 6% return required to pay for the base benefit. This means that the cost-of-living component is pre-funded but the investment component is not.

According to the MSRS Handbook, the Minnesota's gain-sharing mechanism resulted, on average, in about a 7% increase in monthly benefits each year over the last 12 years. Now Minnesota reports problems since markets have fallen. It is expected that future post-retirement increases from the investment component will be substantially lower than those paid over the last few years. The increases for the next several years are projected to likely match inflation, up to 2.5%. Minnesota's Member Handbook states: "Unless the stock market rebounds dramatically, there will not be an investment component [to provide for increases after retirement]."

New York City

The New York City Employees' Retirement System (NYCERS) experimented with a gain-sharing mechanism referred to as "skimming" in order to improve retirement benefits for corrections officers. The benefit was to be funded with a portion of the earnings generated through NYCERS' equity investments. Excess earnings would be "skimmed" and put into a separate fund. The assets and earnings of this separate fund would be used to pay for the additional retirement benefits. In effect, excess earnings were moved from one "pot" to another, effecting a "cap" on earnings. As discussed earlier in this paper, a cap on earnings increases the need for higher contributions in the future.

When skimming was first proposed, there was some debate about the fiscal impact of skimming. The city's chief actuary estimated that the plan could cost $68-130 million annually in increased pension contributions using a net present value approach that discounted all future added benefits plus foregone investment income to its present value. The City Council estimated a cost of $6 million in 2000 rising to $75 million by 2009, and continuing to increase thereafter, using a "pay-as-you-go" approach that reflected the costs of the skim as they would occur on a year to year basis. That is, the city's contribution would not reflect any of the cost of expected future payments or NYCERS earnings foregone as a result of those payments.

Skimming passed, but was later repealed and replaced with a benefit of equivalent value.

Conclusion

Gain-sharing is a mechanism for triggering benefit enhancements. It is not a funding mechanism. The benefits that are distributed when there is a gain-sharing event are part of the liabilities of the affected pension plans and must be paid for just like any other benefit enhancement. Gain-sharing was initiated in response to the favorable market conditions of the late 1990's. Since the extraordinary gains of that period were spent for benefit enhancements, those gains were not available to offset the market losses that followed. Thus future contribution rate increases must respond not only to recent market losses, but also to the ongoing liabilities for benefit enhancements associated with gain-sharing events.

Gain-sharing experience over last five years has not been consistent with its original goals, nor is it consistent with the current policies codified in the actuarial funding chapter. The gain-sharing program is founded on a "pay-as-you-go" philosophy, while long-term funding objectives for the retirement systems at large utilize systematic actuarial pre-funding.